(1)

89-280

No. ________

In The

Supreme Court of the United States

October Term, 1989

ESTATE OF DANIEL LEAVITT, DECEASED, CHARLES D. FOX, III, EXECUTOR; ESTATE OF EVELYN M. LEAVITT, DECEASED, CHARLES D. FOX, III, EXECUTOR,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED

Internal Revenue Code Section 1374(c)(2) permits a shareholder in a subchapter S corporation to deduct his portion of the corporation's net operating loss up to the combined amount of the shareholder's basis in the corporation's stock plus the basis of indebtedness of the corporation to the shareholder. The petitioner guaranteed his corporation's loan at a time when the corporation was insolvent.

The questions presented are:

1. Should a shareholder in a subchapter S corporation be able to increase his stock basis by reason of his guarantee of a corporate loan when, under traditional debt-equity principles, his guarantee is a capital contribution to the corporation? If so, what is the amount of his increase in basis?

2. Should a showing of economic outlay by the shareholder be required prior to application of a debt-equity test?

LIST OF PARTIES

The parties to the proceedings below were the petitioners Estate of Daniel Leavitt, Deceased, Charles D. Fox, III, Executor, and Estate of Evelyn M. Leavitt, Charles D. Fox, III, Executor, and the respondent Commissioner of Internal Revenue. Anthony D. Cuzzocrea and Marjorie F. Cuzzocrea were also appellants in the Court below. It is petitioners' understanding that the Cuzzocreas have opted not to pursue a writ of certiorari, and they are, therefore, not named as parties herein.

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In The

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Petitioners,

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners, Estate of Leavitt, et al., respectfully pray that a writ of certiorari issue to review the judgment and the opinion of the United States Court of Appeals for the Fourth Circuit entered in the above-entitled proceeding on May 19, 1989.

OPINIONS BELOW

The reported opinion of the United States Court of Appeals for the Fourth Circuit and the opinion of the

United States Tax Court appear respectively at Appendix page 1 and Appendix page 21 attached hereto.[1]

JURISDICTION

Invoking jurisdiction under Internal Revenue Code Section 6214, petitioners brought this suit in the United States Tax Court. On April 29, 1989, the Tax Court issued a Final Opinion following a Memorandum Opinion issued on February 10, 1988. On July 18, 1989, petitioners filed a Notice of Appeal to the United States Court of Appeals for the Fourth Circuit.

The judgment of the Court of Appeals for the Fourth Circuit was dated and entered on May 19, 1989. This Petition for Certiorari is filed within ninety days of that date.

The jurisdiction of this Court to review the judgment of the Fourth Circuit is invoked under Internal Revenue Code Section 7482(a)(1) and 28 U.S.C. §1254(1).

STATUTES INVOLVED

Internal Revenue Code Section 1374 (hereinafter referred to as "Section 1374" or "§ 1374") as in effect during the years in issue provided:[2]

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[1] All references to pages of the Appendix hereinafter will be cited as "App. ___."

[2] Section 1374(c)(2) was reenacted by section 2 of the Subchapter S Revision Act of 1982 in Internal Revenue Code Section 1366(d)(1). Section 1366(d)(1) is currently in effect and is virtually identical to Section 1374(c)(2).

CORPORATION NET OPERATING LOSS ALLOWED TO SHAREHOLDERS

Sec. 1374 [1954 Code].

(a) GENERAL RULE. – A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) ALLOWANCE OF DEDUCTION. – Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)). The deduction allowed by this subsection shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

(c) DETERMINATION OF SHAREHOLDER'S PORTION. –

(1) IN GENERAL. – For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this paragraph, a shareholder's pro rata share of the

corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

(2) LIMITATION. – A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of –

(A) the *adjusted basis* (determined without regard to any adjustment under section 1376 for the taxable year) of the *shareholder's stock* in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

(B) the *adjusted basis* (determined without regard to any adjustment under section 1376 for the taxable year) of *any indebtedness* of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation). [Emphasis Added]

STATEMENT OF THE CASE

The facts of this case are fully stipulated and therefore undisputed. Petitioner, Estate of Daniel Leavitt, deceased, was a shareholder in VAFLA Corporation ("VAFLA"), having paid $10,000 in 1979 for his shares [App.73.][3] VAFLA was a Virginia corporation incorporated in February, 1979, which elected treatment as a small business corporation under subchapter S for all years in issue. VAFLA acquired and operated the Six-Gun Territory Amusement Park near Tampa, Florida.

VAFLA began experiencing financial difficulties almost immediately. VAFLA's first taxable year was a short, seven-month year ending September 30, 1979. By that date, VAFLA had posted a net operating loss of $265,566.47 along with a retained earnings deficit of $345,370.20. [App.73.] Its debt-to-equity ratio was over 10 to 1. [App.63-64.] By the end of its second taxable year, VAFLA had suffered a net operating loss of $482,181.22, as well as a retained earnings deficit of $1,093,382.56. [App.74.] By September 30, 1981, the end of its third taxable year, VAFLA's retained earnings deficit rose again to $1,908,680.22 and net operating losses totaled $475,175.70. [App.74.]

From August 2, 1979 through August 27, 1979, Daniel Leavitt ("Leavitt"), along with six other VAFLA shareholders, signed guarantee agreements whereby he agreed to be jointly and severally liable for any indebtedness

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[3] Petitioner, Estate of Evelyn M. Leavitt, deceased, is a party hereto because petitioners filed joint tax returns for the years in question.

which VAFLA might owe to the Bank of Virginia ("Bank"). [App.74-75.]

Charles M. Harris, Jr., then Vice President of the Bank, was the loan officer responsible for VAFLA's loan account. [App.75.] On or before September 30, 1979, Mr. Harris approved a loan (the "Loan") to VAFLA in the amount of $300,000.00, as evidenced by its promissory note dated September 12, 1979. [App.75.]

It is undisputed that the Bank would not have made the Loan but for the personal guarantees of the seven shareholders of VAFLA, including Leavitt. [App.79.]

At the time the Loan was made VAFLA was insolvent. VAFLA's liabilities exceeded its assets, and VAFLA had so little cash available that it could not even meet its cash flow requirements. Virtually all of the assets of VAFLA had been put up as security for a purchase money indebtedness of approximately $1,000,000.00 to National Service Industries, Inc. [App.75.]

The income statement used to process the Loan was for the period of March through May of 1979, which period represented VAFLA's first three months of operations. The income statement showed that during those first three months, VAFLA had already experienced a loss of $142,410.16, resulting in a negative net worth of $82,410.16 as of May 31, 1979. [App.79.] Leavitt and the six other shareholders who guaranteed the Loan (hereinafter referred to collectively as the "Shareholder-Guarantors"), in contrast, had at the time of the Loan, an aggregate net worth (according to the financial statements submitted to the Bank) of $3,407,286.00, and immediate liquidity (cash and securities) of $382,542.00.

[App.79.] According to the testimony of Mr. Harris, the Bank officer, the Loan was based *solely* upon the financial strength of the Shareholder-Guarantors, and the Bank was not looking to any of the assets of VAFLA for repayment of the Loan. [App.79.]

The Loan was consistently shown on VAFLA's financial statements and tax returns for its fiscal years ending September 30, 1979, 1980 and 1981, as a loan from shareholders. [App.75.] All payments on the Loan during the years in question were made by VAFLA, but the corporate loan payments were not treated as cash distributions to shareholders.

A shareholder in a subchapter S corporation can deduct his share of a corporation's net operating loss ("flow-through loss") to the extent of the combined amount of his basis in equity and his basis in loans to the corporation. Petitioners argued that due to the insolvency of VAFLA at the time the guarantees were signed, the shareholder guarantees were really capital contributions under traditional debt-equity principles, resulting in an increase in stock basis. The Tax Court majority, over a strong dissent, held that a debt-equity analysis could not be applied in this case because it did not want to extend what it perceived to be a subchapter C corporation rule to subchapter S corporations. [App.38.] The Tax Court, therefore, limited the deductibility of flow-through losses to the initial $10,000.00 investment in VAFLA.

The Fourth Circuit Court of Appeals affirmed the Tax Court result, but for a different reason. It held that economic outlay was necessary for a basis increase under Sections 1374(c)(2)(A) and (B) (relating to basis in equity

and debt, respectively) and that in the absence of actual payment on a shareholder's guarantee, there is no economic outlay. It refused to apply a debt-equity test before an economic outlay test even though under well established case law, a shareholder guarantee is recast under proper facts as a loan to the shareholder followed by his deemed cash contribution to the corporation. Had a debt-equity test been applied in this case, Leavitt would have been deemed to have made a capital contribution of cash to VAFLA, and the economic outlay test would have been satisfied.

REASONS FOR GRANTING THE WRIT

THE FOURTH CIRCUIT'S AND TAX COURT'S REQUIREMENT OF EVIDENCE OF ECONOMIC OUTLAY AS A PREREQUISITE TO INITIATING A TRADITIONAL DEBT-EQUITY ANALYSIS NEGATES CONGRESSIONAL INTENT AS STATED IN I.R.C. SECTION 1374(c)(2), MISAPPLIES PRIOR PRECEDENT OF THIS COURT, AND CREATES A SPLIT IN AUTHORITY AMONG THE CIRCUIT COURTS OF APPEAL. REVIEW BY THIS COURT IS NECESSARY TO ADDRESS THIS FAULTY PRECEDENT WHICH HAS ALREADY BEEN APPLIED BY THE TAX COURT IN AT LEAST THREE SUBSEQUENT DECISIONS.

A. The Decisions Below Create a Split in the Circuits and Constitute a Radical Departure from Prior Tax Law.

In derogation of congressional mandate, the U.S. Court of Appeals for the Fourth Circuit and the U.S. Tax

Court have manufactured a new "economic outlay" threshold to the application of traditional debt-equity principles in determining whether a shareholder's guarantee of a corporate debt should be treated as a capital contribution. This unprecedented approach creates an injustice in that shareholders who are actually at risk in order to provide their corporations with needed capital no longer get deductions which Congress intended them to have. Such a radical departure from well established tax principles creates a split among the Circuit Courts of Appeal which requires resolution by this Court.

The Fourth Circuit's refusal to apply a debt-equity test without a prior showing of economic outlay directly conflicts with the Eleventh Circuit's ruling in *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (debt-equity analysis should be applied to determine when a shareholder's guarantee of a loan made to a subchapter S corporation is to be treated as an equity investment for section 1374(c) stock basis purposes).[4] Its refusal also conflicts with the traditional debt-equity analysis of shareholder guarantees applied by the First, Fifth and Ninth Circuits. *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976), *cert. denied*, 430 U.S. 907 (1977) (debt-equity analysis applied with the result that a shareholder's agreement to indemnify a bonding company which bonded the shareholder's corporation was in substance a capital contribution); *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972) (debt-equity analysis applied with the result

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[4] J. Eustice & J. Kuntz in *Taxation of S Corporations*, par. 10.03[2] [i], n.184 (Rev. Ed. 2d Supp. 1987), refer to *Selfe v. United States, supra*, as a "well reasoned opinion."

that a shareholder's guarantee of corporate debt was, in substance, a capital contribution, i.e., a loan to the shareholder followed by a deemed cash contribution to the corporation, resulting in the shareholder being taxed on constructive dividends for corporate loan repayments); *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967) (debt-equity analysis applied with the result that a shareholder guarantee of a corporate loan was not, in substance, a capital contribution, so the shareholder did not have constructive dividend income when the corporation made loan payments as claimed by the government, and the corporation was entitled to deduct its interest payments). As stated by Judge Fay in the Tax Court's dissent (the "Dissent"):

> Other than the majority opinion, there exists, to my knowledge, no authority that refuses to apply traditional debt-equity principles in determining whether a shareholder-guaranteed corporate debt is in substance a capital contribution. [App.57.]

The Dissent further states that the Tax Court majority's novel interpretation of the law (and the Fourth Circuit's subsequent affirmance) undermines the established precedent that a taxpayer, upon a proper showing of facts, will be permitted to increase his basis in the corporation's stock.

> [The Tax Court] has dangled an elusive carrot before taxpayers' eyes for over 15 years stating that on the proper showing, a shareholder-guaranteed corporate debt can be characterized as a capital contribution. Petitioners have here made the proper showing, to which the majority states, 'we were only kidding.' (footnote omitted) [App.70.]

The precedent in question is so well established that the Dissent felt compelled to note that were this case appealable to the First, Fifth, Ninth or Eleventh Circuit Courts of Appeal, a result different from the result reached by the majority might well have been mandated. [App.56-57.]

The importance of the case in question is highlighted by the fact that in the few months since it was decided, at least three cases have relied solely upon this new precedent to deny basis increases to taxpayers similarly situated. See *Douglass D. Fear, et al. v. Commissioner*, T.C. Memo. 1989-211 (which involved VAFLA); *Roesch, Jr. v. Commissioner*, T.C. Memo. 1989-158; *Erwin III v. Commissioner*, T.C. Memo. 1989-80.

B. The Decisions Below Erase the Critical Distinction Between Debt and Equity in I.R.C. Section 1374(c)(2) by Misapplying the Concept of Economic Outlay as a Prerequisite for Initiating Traditional Debt-equity Analysis.

Internal Revenue Code Sections 1374(c)(2)(A) and 1374(c)(2)(B) control in determining the amount of net operating losses which a small business corporation's shareholder may deduct. The total amount which can be deducted is limited to the combined amount of a shareholder's basis in stock of the subchapter S corporation, pursuant to 1374(c)(2)(A) ("Equity Basis") and a shareholder's basis in any indebtedness of the corporation to the shareholder pursuant to Section 1374(c)(2)(B) ("Debt Basis").

A shareholder-guarantor is entitled to increase his Debt Basis if and to the extent the corporation is indebted to the shareholder. This increase happens only when the loan to the corporation is really a loan (and not equity because of its thin capitalization or other factors of the debt-equity test) and when the shareholder has economic outlay by actually making a payment to the corporation's creditor pursuant to his guarantee. Debt to the shareholder exists because he is subrogated to the rights of the creditor. *Putnam v. Commissioner,* 352 U.S. 82 (1956).

Similarly, a shareholder-guarantor would be entitled to increase his Equity Basis only if the guarantee were a capital contribution. If the substance of a guarantee is a capital contribution under a debt-equity analysis, courts have found that the transaction is really a loan from a third party to the shareholder followed by the shareholder's contribution of the loan proceeds to the capital of the corporation. *Plantation Patterns, Inc. v. Commissioner, supra.*

If a shareholder guarantee is really an equity contribution under a debt-equity analysis, the economic outlay test is automatically satisfied because the shareholder has contributed cash to the corporation. To compute the amount of Leavitt's increase in basis, state law should be applied to determine his legal rights and obligations with respect to his joint and several guarantee of the corporate debt. [App.67-68.]

1. Traditional debt-equity analysis would permit leavitt to increase his basis in equity based upon a showing that the guarantee met the requirements of a deemed capital contribution.

Federal tax law has long established debt-equity principles for use in determining if any given transaction involves debt as opposed to equity regardless of the transaction's label or form. Therefore, no matter which test a taxpayer relies upon (by calling the guarantee either a loan or a capital contribution), traditional debt-equity principles will be applied to ascertain whether a guarantee is, in substance, a loan or, in substance, a capital contribution.[5]

Over the years, two separate bodies of case law have evolved with respect to increasing shareholder basis, with one body of law focusing on cases in which it was

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[5] The traditional debt-equity factors include the following: (1) the label given the instrument; (2) the presence or absence of a fixed maturity date; (3) the source of payments thereon; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to other creditors; (7) the intent of the parties; (8) "thin" or inadequate capitalization; (9) identity of interest between creditors and stockholders; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets, and (13) the failure of the debtor to repay on the due date or to seek a postponement . . . *In re Lane,* 742 F.2d 1311 (11th Cir. 1984); *Texas Farm Bureau v. United States,* 725 F.2d 307, 311 (5th Cir. 1984); *Estate of Mixon v. United States,* 464 F.2d 394, 410, (5th Cir. 1972); *Fin Hay Realty Co. v. United States;* 398 F.2d 694, 696 (3d Cir. 1968).

determined that Debt Basis was the true substance of the inquiry pursuant to § 1374(c)(2)(B) ("Debt Cases") and the other focusing on cases in which Equity Basis was determined to be the true substance of the inquiry ("Equity Cases"). *Selfe,* which directly conflicts with the Fourth Circuit's opinion, is a classic Equity Case and clearly distinguishes between the equity and debt analyses.

The Courts below, however, disregarded the fundamental distinctions between analyzing Equity Basis and Debt Basis. In its opinion, the Fourth Circuit states that " . . . [petitioners] fail to distinguish between the initial question of economic outlay and the secondary issue of debt or equity. Only if the first question had an affirmative answer, would the second arise." [App.8.] The Fourth Circuit (along with the Tax Court) has erroneously mandated that petitioners establish an economic outlay prior to resorting to a debt-equity analysis under § 1374. To the contrary, if a debt-equity analysis results in an equity conclusion, the economic outlay test is *automatically* satisfied because of the deemed cash contribution. Therefore, the Fourth Circuit's insistence on first applying economic outlay places the taxpayer in a "Catch-22." He cannot establish economic outlay without applying a traditional debt-equity analysis. However, he is barred from a debt-equity analysis unless he first proves economic outlay.

2. Applying an economic outlay test has never been a prerequisite for the application of a debt-equity analysis.

The imposition of economic outlay as an obstacle to the application of debt-equity principles is unprecedented and

flies in the face of numerous well-reasoned opinions.[6] The decisions below and the subsequent Tax Court decisions relying thereon are the only authority for such a proposition. Economic outlay has, of course, played an important role in Debt Cases because an indebtedness from a corporation to its shareholder must exist before the shareholder can have any Debt Basis. In the context of a shareholder guarantee of a corporate loan, indebtedness of the corporation to the shareholder exists after the shareholder pays the corporation's creditor pursuant to his guarantee and becomes the corporation's creditor himself. Courts have held repeatedly that in a Debt Case the mere guarantee of corporate debt by shareholders is insufficient to create a debt of the corporation to its shareholders for purposes of Debt Basis. See *Raynor v. Commissioner,* 50 T.C. 762 (1968). A good example is *Bader v. Commissioner,* T.C. Memo. 1987-30, which involved a shareholder guaranteed bank loan to an S corporation. There were no allegations or facts presented that the debt and guarantee in question should be considered a contribution to capital of the corporation rather than debt of the corporation. The case was a pure Debt Case, and the shareholders had not been

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[6] See *Blum v. Commissioner,* 59 T.C. 436, 439-440 (1972); *Smyers v. Commissioner,* 57 T.C. 189, 198 (1971); *Santa Anita Consolidated, Inc. v. Commissioner,* 50 T.C. 536, 550 (1968); *La Staiti v. Commissioner,* T. C. Memo. 1980-547; *Selfe v. United States, supra; In re Lane, supra; Casco Bank & Trust Co. v. United States, supra; Plantation Patterns Inc v. Commissioner, supra; Murphy Logging Co. v. United States, supra; Kavich v. United States,* 507 F. Supp. 1339 (D. Neb. 1981); *In re Breit,* 460 F. Supp. 873, 875 (E.D. Va. 1978); *Ackerson v. United States,* 277 F. Supp. 475, 477 (W.D. Wash. 1966); and *Fors Farms, Inc. v. Commissioner,* an unreported case (W.D. Wash. 1966) (66 – U.S.T.C. par. 9206, 17 A.F.T.R. 2d 222).

called upon to pay pursuant to their guarantees. The Court held that the shareholders could not increase their Debt Basis.

On the other hand, the Equity Cases rarely focus on economic outlay because there is always economic outlay if the debt or guarantee in question is really a capital contribution since the shareholders are deemed to have made a cash contribution to the corporation.

In re Lane, 742 F.2d 1311 (11th Cir. 1984), is an example of an Equity Case. A shareholder had guaranteed corporate debt and was ultimately called upon to pay the corporation's creditor pursuant to his guarantee. The taxpayer was seeking a bad debt deduction. The Court applied a debt-equity test and held that at the time the guarantee was executed the guarantee was in substance a capital contribution to the corporation. Therefore, when the shareholder paid pursuant to the guarantee, the corporation was not indebted to him because there was no corporate debt to which he could be subrogated in the first place. The taxpayer was denied his bad debt deduction. Had the Court required a finding of economic outlay prior to applying the debt-equity test, the lucky shareholder would have gotten a deduction to which he was not entitled.

The conflict between the approach of the Courts below and all prior tax law is clear. Prior tax law has always involved a preliminary debt-equity analysis to determine whether the guarantee in question is, in substance, a loan or a capital contribution. The conclusions drawn under a debt-equity analysis determine whether 1374(c)(2)(A) or 1374(c)(2)(B) is applicable. The Courts

below, however, take the requirement of economic outlay and position it as an unauthorized roadblock to the two distinct avenues established by § 1374(c)(2). Until now, there has been no context in which a Court has imposed any prerequisite to the application of a debt-equity analysis.[7]

Confirmation of the confusion of the courts below as to the bifurcated operation of Section 1374 is found in the citations relied upon in the opinions below for justification of their emphasis on economic outlay. The cases relied upon are almost exclusively Debt Cases, as the Dissent repeatedly notes. For example, a principal case relied on by the Tax Court is *Borg v. Commissioner,* 50 T.C. 257 (1968), which involved two issues. First, the corporation owed its shareholder money for unpaid salary, which debt to the shareholder was represented by the corporation's promissory note. The shareholder, a cash-basis taxpayer, had not taken the salary into income and, thus,

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[7] See, *Blum v. Commissioner, supra; Smyers v. Commissioner, supra; Santa Anita Consolidated, Inc. v. Commissioner, supra; J.A. Maurer, Inc. v. Commissioner,* 30 T.C. 1273, 1290 n.2 (1958); *Schneiderman v. Commissioner,* T.C. Memo. 1987-551; *Gurda v. Commissioner,* T.C. Memo. 1987-394; *Bader v. Commissioner, supra; Blackman v. Commissioner,* T.C. Memo. 1981-244; *Albert v. Commissioner,* T.C. Memo. 1980-567; *LaStaiti v. Commissioner, supra; Selfe v. United States,* 778 F.2d 769, 774 (11th Cir. 1985); *In re Lane,* 742 F.2d 1311, 1319-1320 (11th Cir. 1984); *Casco Bank & Trust Co. v. United States,* 544 F.2d 528, 534-535 (1st Cir. 1976); *cert. denied,* 430 U.S. 907 (1977) *Plantation Patterns, Inc. v. Commissioner,* 462 F.2d 712, 722-724 (5th Cir. 1972), affg. T. C. Memo. 1970-182; *Murphy Logging Co. v. United States, supra; In re Breit, supra; Ackerson v. United States, supra;* and *Fors Farms, Inc. v. Commissioner, supra.*

had no income tax basis in the note. The Court held that although the taxpayer had Section 1374(c)(2)(B) indebtedness, his basis in the debt was zero so he could not increase his flow-through loss limit. The second issue involved a shareholder guaranteed corporate loan. There was no allegation that the guarantee was a capital contribution or that the corporate debt involved was really equity, so a pure Debt Basis analysis was appropriate. The Court held that there was no Section 1374(c)(2)(B) Debt Basis increase, because without economic outlay by the shareholder (paying on the guarantee), there is no corporate indebtedness to the shareholder. In short, *Borg* is a classic Debt Case, and its discussion of economic outlay has nothing to do with economic outlay being a condition precedent to the application of a debt-equity test.

Nevertheless, the majority opinion of the Tax Court found the following sentence from *Borg v. Commissioner, supra,* to be determinative in this case:

> Since the services performed by petitioner Joe E. Borg had no cost within the meaning of section 1012, his notes for unpaid salary had a basis of zero and, therefore, added nothing to the *adjusted basis for INDEBTEDNESS* for the purpose of computing the section 1374(c)(2) limitation on net operating loss deduction. [Emphasis added by Dissent]. [App.45.]

As stated by the Dissent, from the above quote from *Borg* " . . . the majority makes the quantum leap without explanation to the conclusion that: 'Without capital outlay or a realization of income, as required by *Borg,* petitioners cannot increase *their adjusted basis in their STOCK in the corporation.*' " [App.45.]

Even when Equity Cases were cited by the Courts below their holdings were misapplied. For example, *Blum v. Commissioner,* 59 T.C. 436 (1972) was erroneously read as requiring a separate economic outlay test prior to the application of debt-equity principles.

To the contrary, the *Blum* Court actually applied traditional debt-equity principles and determined that an increase in Equity Basis, given the facts therein, was not permitted because the taxpayers did not meet their burden of proof. In referring to the *Blum* case, the Dissent notes that:

> "the Tax Court did not decline to apply traditional debt-equity principles because the taxpayer failed in his burden of proof, but rather applied traditional debt-equity principles to determine that the taxpayer failed in his burden of proof. This distinction is more than semantical. [P]etitioners herein have carried their burden of proof." [App.48.]

It is noteworthy that Judge Fay, the forceful Dissent in this case, was the author of the *Blum* decision.

This Court has long established that traditional debt-equity principles are applied to determine the substance of a transaction. After such a determination is made, the substance of the transaction, not the form, is to be evaluated for federal income tax purposes. See *Diedrick v. Commissioner,* 457 U.S. 191, 195 (1982). The Fourth Circuit's and the Tax Court's unprecedented reliance on their newly created application of the economic outlay doctrine has the effect of looking purely to a transaction's form, without regard to its substance. For example, a shareholder's guarantee of a corporate obligation will be

automatically rejected for purposes of increasing basis without regard for, or inquiry into, the true substance and nature of the transaction.

The decisions appealed from have, thus, created dangerous precedent which already has generated a string of recent opinions adopting this new tax analysis.

Commentators, cognizant of this questionable trend, have roundly criticized the opinions below as being in contravention of well reasoned and well established precedent. *See* Powell, *Will S Shareholder Guarantees Ever Increase Basis?*, 68 J. Tax'n 12 (1988); *Tax Court Rejects Constructive Capital Contribution of Selfe v. U.S.*, 8 *ABA Section of Taxation Newsletter, Tax Commentaries*. 71 (Summer 1989).

> Most of the interest in this case is probably the result of the hope that the inequity of denying basis to S corporation shareholders when they have put their personal assets at risk to enable their corporations to raise needed funds while granting basis to limited partners for nonrecourse indebtedness that they have not guaranteed can be rectified judicially rather than legislatively. (ABA Newsletter, p. 71)

The precedent created by the Courts below is directly at odds with all prior law. Plenary consideration of this matter by this Court is essential.

CONCLUSION

It is respectfully submitted that by requiring the application of an economic outlay test prior to a debt-equity test, the decisions of the Fourth Circuit Court of

Appeals and United States Tax Court erases the distinction between Sections 1374(c)(2)(A) and 1374(c)(2)(B), and ignores the holdings in well established case law. The decision conflicts directly with *Selfe v. U.S.*, 778 F.2d 769 (11th Cir. 1985), and with the reasoning of *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976), *cert. denied*, 430 U.S. 907 (1977) *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967), *Plantation Patterns, Inc. v. Comm.*, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972) and *Blum v. Commissioner*, 59 T.C. 436, 439-440 (1972).

This petition involves a pure question of law on an important tax issue which has already had a dramatic impact on recent Tax Court decisions.

For all of the foregoing reasons, this Court should grant certiorari, and the judgment below should be reversed.

Respectfully submitted,

ESTATE OF LEAVITT,
DECEASED, ET AL

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UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 88-3129

ESTATE OF DANIEL LEAVITT, Deceased,
Charles D. Fox, III, Executor; ESTATE
OF EVELYN M. LEAVITT, Deceased,
Charles D. Fox, III, Executor;
ANTHONY D. CUZZOCREA; MARJORIE F.
CUZZOCREA,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court. Judge Nims, Tax Court Judge. (Tax Ct. Nos. 32041-84/36453-84).

Argued: February 9, 1989 Decided: May 19, 1989

Before MURNAGHAN, Circuit Judge, Butzner, Senior Circuit Judge, and Tilley, United States District Judge for the Middle District of North Carolina, sitting by designation.

Dianne E. H. Wilcox (Nicholas C. Conte, WOODS, ROGERS & HAZLEGROVE on brief) for Appellants. Teresa Ellen McLaughlin (Gary R. Allen, Richard Farber, Tax Division, DEPARTMENT OF JUSTICE; William E. Rose, Jr., Assistant Attorney General on brief) for Appellee.

MURNAGHAN, Circuit Judge:

The appellants, Anthony D. and Marjorie F. Cuzzocrea and the Estate of Daniel Leavitt, Deceased, et al., appeal the Tax Court's decision holding them liable for tax deficiencies for the tax years 1979, 1980 and 1981. Finding the appellants' arguments unpersuasive, we affirm the Tax Court.

I.

As shareholders of VAFLA Corporation,[1] a subchapter S corporation during the years at issue, the appellants claimed deductions[2] under § 1374 of the Internal Revenue Code of 1954[3] to reflect the corporation's operating losses

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[1] VAFLA is a Virginia corporation incorporated in February 1979 to acquire and operate the Six-Gun Territory Amusement Park near Tampa, Florida. At that time, both Cuzzocrea and Leavitt each paid $10,000 for their respective shares of VAFLA. Therefore, the adjusted bases of their stock amounted to $10,000 each, the cost of the stock.

[2] The Leavitts deducted a loss of $13,808 attributable to the corporation on their 1979 joint federal income tax return. The appellee disallowed $3,808 of that deduction. The Cuzzocreas deducted losses of $13,808, $29,921 and $22,746 attributable to the corporation on their 1979, 1980 and 1981 joint federal income tax returns, respectively. The appellee disallowed all of the deductions in excess of $10,000.

[3] Former § 1374, in effect during the years in issue, provided:

> (a) GENERAL RULE. – A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross

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income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) ALLOWANCE OF DEDUCTION. – Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)). The deduction allowed by this subsection shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

(c) DETERMINATION OF SHAREHOLDER'S PORTION. –

. . . (2) LIMITATION. – A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of –

(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as the day before the day of such sale or other disposition), and

(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the

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during the three years in question.[4] The Commissioner disallowed deductions above the $10,000 bases each appellant had from their original investments.

The appellants contend, however, that the adjusted bases in their stock should be increased to reflect a $300,000 loan which VAFLA obtained from the Bank of Virginia ("Bank") on September 12, 1979, after the appellants, along with five other shareholders ("Shareholders-Guarantors"), had signed guarantee agreements whereby each agreed to be jointly and severally liable for all indebtedness of the corporation to the Bank.[5] At the time of the loan, VAFLA's liability exceeded its assets,[6] it could not meet its cash flow requirements and it had virtually

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taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

[4] The first taxable year of VAFLA consisted of seven months and ended on September 30, 1979. The corporation had suffered a net operating loss of $265,566.47 and had a retained earnings deficit of $345,370.29. During its second taxable year ending September 30, 1980, the corporation suffered a net operating loss of $482,181.22 and had a retained earnings deficit of $1,093,383.56. During its third taxable year ending September 30, 1981, the corporation suffered a net operating loss of $475,175.70 and had a retained earnings deficit of $1,908,680.22.

[5] All the guarantees to the Bank were unlimited except the guarantee of Cuzzocrea which was limited to $300,000. The Shareholders-Guarantors had an aggregate net worth of $3,407,286 and immediate liquidity of $382,542.

[6] *See supra* note 4.

no assets to use as collateral. The appellants assert that the Bank would not have lent the $300,000 without their personal guarantees.

VAFLA's financial statements and tax returns indicated that the bank loan was a loan from the Shareholders-Guarantors. Despite the representation to that effect, VAFLA made all of the loan payments, principal and interest, to the Bank. The appellants made no such payments. In addition, neither VAFLA nor the Shareholders-Guarantors treated the corporate payments on the loan as constructive income taxable to the Shareholders-Guarantors.

The appellants present the question whether the $300,000 bank loan is really, despite its form as a borrowing from the Bank, a capital contribution from the appellants to VAFLA. They contend that if the bank loan is characterized as equity, they are entitled to add a *pro rata* share of the $300,000 bank loan to their adjusted bases, thereby increasing the size of their operating loss deductions.[7] Implicit in the appellants' characterization of the bank loan as equity in VAFLA is a determination that the Bank lent the $300,000 to the Shareholders-Guarantors

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[7] Former § 1374 of the 1954 tax code which was in effect during the years in issue provides that a shareholder of an electing small business corporation may deduct from gross income an amount equal to his or her portion of the corporation's net operating loss to the extent provided for in § 1374(c)(2). Such deduction is limited, however, to the sum of (a) the adjusted basis of the shareholder's stock in the corporation, and (b) the adjusted basis of any indebtedness of the corporation to the shareholder, as determined as of the close of the corporation's taxable year.

who then contributed the funds to the corporation. The appellants' approach fails to realize that the $300,000 transaction, regardless of whether it is equity or debt, would permit them to adjust the bases in their stock if, indeed, the appellants, and not the Bank, had advanced VAFLA the money. The more precise question, which the appellants fail initially to ask, is whether the guaranteed loan from the Bank to VAFLA is an economic outlay of any kind by the Shareholders-Guarantors. To decide this question, we must determine whether the transaction involving the $300,000 was a loan from the Bank to VAFLA or was it instead a loan to the Shareholders-Guarantors who then gave it to VAFLA, as either a loan or a capital contribution.

Finding no economic outlay, we need not address the question, which is extensively addressed in the briefs, of whether the characterization of the $300,000 was debt or equity.

II.

To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay on the part of the shareholder. *See Brown v. Commissioner,* 706 F.2d 755, 756 (6th Cir. 1983), affg. T.C. Memo 1981-608 (1981) ("In similar cases, the courts have consistently required some economic outlay by the guarantor in order to convert a mere loan guarantee into an investment."); *Blum v. Commissioner,* 59 T.C. 436, 440 (1972) (bank expected repayment of its loan from the corporation and not the taxpayers, *i.e.*, no economic outlay from tax-

payers).[8] A guarantee, in and of itself, cannot fulfill that requirement. The guarantee is merely a promise to pay in the future if certain unfortunate events should occur. At the present time, the appellants have experienced no such call as guarantors, have engaged in no economic outlay, and have suffered no cost.[9]

The situation would be different if VAFLA had defaulted on the loan payments and the Shareholders-Guarantors had made actual disbursements on the corporate indebtedness. Those payments would represent corporate indebtedness to the shareholders which would increase their bases for the purpose of deducting net operating losses under § 1374(c)(2)(B). *Brown*, 706 F.2d.at 757. *See also Raynor v. Commissioner*, 50 T.C. 762, 770-71 (1968) ("No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation.").

The appellants accuse the Tax Court of not recognizing the critical distinction between § 1374(c)(2)(A) (adjusted basis in stock) and § 1374(c)(2)(B) (adjusted basis in indebtedness of corporation to shareholder).

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[8] Even the Eleventh Circuit case on which the appellants heavily rely applies this first step. *See Selfe v. United States*, 778 F.2d 769, 772 (11th Cir. 1985) ("We agree with *Brown* inasmuch as that court reaffirms that economic outlay is required before a stockholder in a Subchapter S corporation may increase her basis.").

[9] Basis of property shall be the cost of such property. 26 U.S.C. § 1012. "Cost" is defined as the "amount paid" for property "in cash or other property." 26 C.F.R. § 1.1012-1(a).

They argue that the "loan" is not really a loan, but is a capital contribution (equity). Therefore, they conclude, § 1374(c)(2)(A) applies and § 1374(c)(2)(B) is irrelevant. However, the appellants once again fail to distinguish between the initial question of economic outlay and the secondary issue of debt or equity. Only if the first question had an affirmative answer, would the second arise.

The majority opinion of the Tax Court, focusing on the first issue of economic outlay, determined that a guarantee, in and of itself, is not an event for which basis can be adjusted. It distinguished the situation presented to it from one where the guarantee is triggered *and actual payments are made.* In the latter scenario, the first question of economic outlay is answered affirmatively (and the second issue is apparent on its face, *i.e.*, the payments represent indebtedness from the corporation to the shareholder as opposed to capital contribution from the shareholder to the corporation). To the contrary is the situation presented here. The Tax Court, far from confusing the issue by discussing irrelevant matters, was comprehensively explaining why the transaction before it could not represent any kind of economic outlay by the appellants.

The Tax Court correctly determined that the appellants' guarantees, unaccompanied by further acts, in and of themselves, have not constituted contributions of cash or other property which might increase the bases of the appellants' stock in the corporation.

The appellants, while they do not disagree with the Tax Court that the guarantees, standing alone, cannot adjust their bases in the stock, nevertheless argue that the "loan" to VAFLA was in its "true sense" a loan to the

Shareholders-Guarantors who then theoretically advanced the $300,000 to the corporation as a capital contribution. The Tax Court declined the invitation to treat a loan and its uncalled-on security, the guarantee, as identical and to adopt the appellants' view of the "substance" of the transaction over the "form" of the transaction they took. The Tax Court did not err in doing so.

Generally, taxpayers are liable for the tax consequences of the transaction they actually execute and may not reap the benefit of recasting the transaction into another one substantially different in economic effect that they might have made. They are bound by the "form" of their transaction and may not argue that the "substance" of their transaction triggers different tax consequences. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579-80 (1977); *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).[10] In the situation of

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[10] On the other hand, the Commissioner is not so bound and may recharacterize the nature of the transaction according to its substance while overlooking the form selected by the taxpayer. *Higgins v. Smith*, 308 U.S. 473, 477 (1940). In doing so, the Commissioner usually applies debt-equity principles to determine the true *nature* of the transaction. As the *Selfe* court noted:

> This principle is particularly evident where characterization of capital as debt or equity will have different tax consequences. Thus in *Plantation Patterns* the court held that interest payments by a corporation on debentures were constructive stockholder dividends and could not be deducted by the corporation as interest payments. There, the former Fifth Circuit recharacterized debt as equity at the insistence of the Commissioner.

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guaranteed corporate debt, where the form of the transaction may not be so clear, courts have permitted the taxpayer to argue that the substance of the transaction was in actuality a loan to the shareholder. *See Blum*, 59 T.C. at 440. However, the burden is on the taxpayer and it has been a difficult one to meet. That is especially so where, as here, the transaction is cast in sufficiently ambiguous terms to permit an argument either way depending on which is subsequently advantageous from a tax point of view.

In the case before us, the Tax Court found that the "form" and "substance" of the transaction was a loan from the Bank to VAFLA and not to the appellants:

> The Bank of Virginia loaned the money to the corporation and not to petitioners. The proceeds of the loan were to be used in the operation of the corporation's business. Petitioners submitted no evidence that they were free to dispose of the proceeds of the loan as they wished. Nor were the payments on the loan reported as constructive dividends on the corporation's Federal income tax returns or on the petitioners' Federal income tax returns during the years in issue. Accordingly, we find that the transaction was in fact a loan by the bank to the corporation guaranteed by the shareholders.

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Selfe, 778 F.2d at 773.

It is important to note that those cases did not involve the question posed here of whether an economic outlay existed because it clearly did. Actual payments were made. The only question was what was the nature of the payments, debt or equity.

Whether the $300,000 was lent to the corporation or to the Shareholders/Guarantors is a factual issue which should not be disturbed unless clearly erroneous. Finding no error, we affirm.

It must be borne in mind that we do not merely encounter naive taxpayers caught in a complex trap for the unwary. They sought to claim deductions because the corporation lost money. If, however, VAFLA had been profitable, they would be arguing that the loan was in reality from the Bank to the corporation, and not to them, for that would then lessen their taxes. Under that description of the transaction, the loan repayments made by VAFLA would not be on the appellants' behalf, and, consequently, would not be taxed as constructive income to them. *See Old Colony Trust Co. v. Commissioner,* 279 U.S. 716 (1929) (payment by a corporation of a personal expense or debt of a shareholder is considered as the receipt of a taxable benefit). It came down in effect to an ambiguity as to which way the appellants would jump, an effort to play both ends against the middle, until it should be determined whether VAFLA was a profitable or money-losing proposition. At that point, the appellants attempted to treat the transaction as cloaked in the guise having the more beneficial tax consequences for them.

Finally, the appellants complain that the Tax Court erred by failing to apply debt-equity principles[11] to deter-

[11] The thirteen factors identified in *In re Lane,* 742 F.2d 1311 (11th Cir. 1984), and used to determine whether a shareholder's advances to a corporation are debt or equity are:

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(1) the names given to the certificates evidencing the indebtedness;

(2) the presence or absence of a fixed-maturity date;

(3) the source of payments;

(4) the right to enforce payment of principal and interest;

(5) participation in management flowing as a result;

(6) the status of the contribution in relation to regular corporate creditors;

(7) the intent of the parties;

(8) 'thin' or adequate capitalization;

(9) identity of interest between creditor and stockholder;

(10) source of interest payments;

(11) the ability of the corporation to obtain loans from outside lending institutions;

(12) the extent to which the advance was used to acquire capital assets; and

(13) the failure of the debtor to repay on the due date or to seek a postponement.

See also 26 U.S.C. § 385.

The appellants correctly state that the First, Fifth and Ninth Circuits have all applied traditional debt-equity principles in determining whether a shareholder's guarantee of a corporate debt was in substance a capital contribution. *See Casco Bank & Trust Co. v. United States,* 544 F.2d 528 (1st Cir. 1976), *cert. denied,* 430 U.S. 907 (1977); *Plantation Patterns v. Commissioner,* 462 F.2d 712 (5th Cir. 1971), *cert. denied,* 409 U.S. 1076 (1972); *Murphy Logging Co. v. United States,* 378 F.2d 222 (9th Cir. 1967). What the appellants fail to point out, however, is that those cases each involved activated guarantees, *i.e.,*

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mine the "form" of the loan. We believe that the Tax Court correctly refused to apply debt-equity principles here, a methodology which is only relevant, if at all,[12] to resolution of the second inquiry – what is the nature of the economic outlay. Of course, the second inquiry cannot be reached unless the first question concerning whether an economic outlay exists is answered affirmatively. Here it is not.

The appellants, in effect, attempt to collapse a two-step analysis into a one-step inquiry which would elimi-

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actual advances or payments on defaults. Therefore, the issue in those cases was not whether the taxpayer had made an "investment" – an economic outlay – in the corporation. The investment was admitted. The issue in those cases asked what was the nature of the investment – equity or debt. None of those cases involved the disallowance of deductions claimed by a shareholder pursuant to § 1374 for his or her share of an electing corporation's operating losses where there had simply been no economic outlay by the shareholder under the guarantee.

[12] In a § 1374 subchapter S corporation case, the inquiry whether or not the economic outlay, assuming there is one, is debt or equity appears not to matter since the economic outlay, regardless of its characterization as debt or equity, will increase the adjusted basis. *See supra* note 7. There are no different tax consequences from the point of view of the taxpayer on the narrow issue of what amount of net operating losses may be deducted. Therefore, application of debt-equity principles in a case such as this one appears to be a red herring. However, we do not reach that issue because the Tax Court's factual finding that the appellants have shown no economic outlay on their part is not clearly erroneous.

nate the initial determination of economic outlay by first concluding that the proceeds were a capital contribution (equity). Obviously, a capital contribution is an economic outlay so the basis in the stock would be adjusted accordingly. But such an approach simply ignores the factual determination by the Tax Court that the Bank lent the $300,000 to the corporation and not to the Shareholders-Guarantors.

The appellants rely on *Blum v. Commissioner,* 59 T.C. 436 (1972), and *Selfe v. United States,* 778 F.2d 769 (11th Cir. 1985), to support their position. However, the appellants have misread those cases. In Blum, the Tax Court declined to apply debt-equity principles to determine whether the taxpayer's guarantee of a loan from a bank to a corporation was an indirect capital contribution.[13]

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[13] The *Blum* court stated:

> The respondent [Commissioner] has argued that the entire equity-contribution argument espoused by petitioner is inimical to the subch. S area. Because of our holding that the facts do not warrant the applicability of this doctrine to the present case we will not consider this rather fascinating question.

Blum, 59 T.C. at 439 n.4. In other words, the *Blum* court never reached the second step of the analysis, if there is a second step, because it found that there was no economic outlay. The Tax Court focused on the first inquiry: "we must find that the bank in substance loaned the sums to petitioner, not the corporation, and that petitioner then proceeded to advance such funds to the corporation." *Id.* at 440. The court found that "there is no evidence to refute the fact that the bank expected repayment of its loan from the corporation and not the petitioner." *Id.*

Similarly, in *Brown,* the Sixth Circuit refused to "accept petitioners' contorted view of the transaction in furtherance of

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The Tax Court held that the taxpayer had failed to carry his burden of proving that the transaction was in "substance" a loan from the bank to the shareholder rather than a loan to the corporation. The *Blum* court found dispositive the fact that "the bank expected repayment of its loan from the corporation and not the petitioner." *Blum*, 59 T.C. at 440.[14]

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their 'substance over form' argument when, as the court below observed, 'the substance matched the form.'" *Brown*, 706 F.2d at 756. In other words, the loan to the corporation was, indeed, a loan to the corporation. *See also In re Breit*, 460 F. Supp. 873 (E.D. Va. 1978).

[14] The appellants and Judge Fay, in his dissent, contend that the Tax Court has misread its earlier opinion. Indeed, Judge Fay was the author of *Blum*. However, the Tax Court, sitting *en banc*, has now had the opportunity to interpret more precisely the language of *Blum* in light of subsequent cases and arguments. *Leavitt v. Commissioner*, 90 T.C. 206 (1988) (court reviewed). We agree with the amplification the Tax Court has given *Blum*.

The confusion may be explained to some degree because the test applied in *Blum* to determine whether the bank lent the money to the corporation or to the shareholders sounds similar to one of the debt-equity factors, *i.e.*, the source of the payments. When focusing on the proper question, however, it becomes clear that the debt-equity principles are simply irrelevant to the determination of whether the $300,000, unquestionably a loan when it left the Bank, went to VAFLA or to the appellants. In *Blum*, the fact that the bank expected repayment from the corporation indicated that it actually lent the funds to the corporation and not the shareholder. Similarly, in the case before us, the fact that VAFLA paid the principal and interest on the $300,000 loan and did not treat the payments as constructive income taxable to the Shareholders-Guarantors, indicated that the Bank actually lent the money to VAFLA and not the appellants.

With regard to *Selfe*, the Tax Court stated:

> the Eleventh Circuit applied a debt-equity analysis and held that a shareholder's guarantee of a loan made to a subchapter's corporation may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor. We respectfully disagree with the Eleventh Circuit and hold that a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder.[15]

The Tax Court then distinguished *Plantation Patterns*, 462 F.2d 712 (5th Cir. 1972), relied on by *Selfe*, because that case involved a C corporation, reasoning that the application of debt-equity principles to subchapter S corporations would defeat Congress' intent to limit a shareholder's pass-through deduction to the amount he or she has actually invested in the corporation.[16]

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[15] Our reading of the *Selfe* opinion, as explained below, does not require us to reject the case completely. In this respect we disagree with the Tax Court's interpretation of *Selfe* in the present case and in *Erwin v. Commissioner*, 56 T.C.M. (CCH) 1343 (1989).

[16] The Committee on Finance of the Senate stated in its report:

> The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under section 1374(c)(2) to the adjusted basis of the shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the

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The Tax Court also distinguished *In re Lane,* 742 F.2d 1311 (11th Cir. 1984), relied on by the *Selfe* court, on the basis that the shareholder had actually paid the amounts he had guaranteed, *i.e.*, there was an economic outlay. In *Lane,* which involved a subchapter S corporation, the issue was "whether advances made by a shareholder to a corporation constitute debt or equity . . . ." *Id.* at 1313. If the advances were debt, then Lane could deduct them as bad debts. On the other hand, if the advances were capital, no bad debt deduction would be permitted. Thus, the issue of adjusted basis for purposes of flow-through deductions from net operating losses of the corporation was not at issue. There was no question of whether there had been an economic outlay.

Although *Selfe* does refer to debt-equity principles, the specific issue before it was whether any material facts existed making summary judgment inappropriate. The Eleventh Circuit said:

> At issue here, however, is not whether the taxpayer's contribution was either a loan to or an equity investment in Jane Simon, Inc. The issue is whether the taxpayer's guarantee of the corporate loan was in itself a contribution to the

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> adjusted basis of any indebtedness of the corporation to the shareholder.

S. Rep. No. 1983, 85th Cong., 2d Sess. at 220, (1958-3 Cum. Bull. at 1141). The word "investment" was construed to mean the actual economic outlay of the shareholder in question. *Perry v. Commissioner,* 54 T.C. 1293, 1296 (1970).

In other words, the economic outlay must be found to exist first.

> corporation [as opposed to a loan from the bank] sufficient to increase the taxpayer's basis in the corporation.

The *Selfe* court found that there was evidence that the bank primarily looked to the taxpayer and not the corporation for repayment of the loan.[17] Therefore, it remanded for "a determination of whether or not the bank primarily looked to Jane Selfe [taxpayer] for repayment [the first inquiry] and for the court to apply the factors set out in *In re Lane* and I.R.C. section 385 to determine if the taxpayer's guarantee amounted to either an equity investment in or shareholder loan to Jane Simon, Inc. [the second inquiry]." *Id.* at 775. The implications are that there is still a two-step analysis and that the debt-equity principles apply only to the determination of the characterization of the economic outlay, once one is found.

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[17] The loan officer so stated during deposition testimony. Furthermore, the bank originally extended a credit line to the taxpayer in consideration of her pledge of 4500 shares of stock in another corporation. When her business was later incorporated, the bank converted the loans made on the existing credit line to corporate loans, accompanied by taxpayer's agreement guaranteeing the corporation's indebtedness to the bank. The Eleventh Circuit noted that "a guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that that pledged stock is not available as collateral for other investments." *Id.* at 772 n.7. Thus, upon remand, the district court could determine that there was an economic outlay on that basis alone, before deciding whether the form of the loan was to the taxpayer or to the corporation.

This particular situation is not before us and we decline to address the question of whether a guarantee can be an economic outlay when accompanied by pledged collateral.

Granted, that conclusion is clouded by the next and final statement of the *Selfe* court: "In short, we remand for the district court to apply *Plantation Patterns* and determine if the bank loan to Jane Simon, Inc. was in reality a loan to the taxpayer." *Id.*[18] To the degree that the *Selfe* court agreed with *Brown* that an economic outlay is required before a shareholder may increase her basis in a subchapter S corporation, *Selfe* does not contradict current law or our resolution of the case before us. Furthermore, to the extent that the *Selfe* court remanded because material facts existed by which the taxpayer could show that the bank actually lent the money to her rather than the corporation, we are still able to agree.[19] It is because of the *Selfe* court's suggestion that debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder

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[18] It is unclear whether the reference to *Plantation Patterns* means that debt-equity principles should be applied or refers back to an earlier statement in the *Selfe* court's opinion which related to the initial inquiry:

> In *Plantation Patterns,* the Fifth Circuit held that a loan is deemed to be made to a stockholder who has guaranteed a corporate note when the facts indicate that the lender is looking primarily to the stockholder for repayment.

Selfe, 778 F.2d at 771.

[19] We note, however, that under the circumstances presented here, the Tax Court resolved that factual determination against the appellants because they could not overcome the uncontradicted fact that they did not treat the loan repayments made by VAFLA as constructive income to them. Such a position was inconsistent with their claim that the transaction was in actuality a loan from the Bank to them followed by their contribution of the $300,000 to the corporation.

or the corporation, that we must part company with the Eleventh Circuit for the reasons stated above.

In conclusion, the Tax Court correctly focused on the initial inquiry of whether an economic outlay existed. Finding none, the issue of whether debt-equity principles ought to apply to determine the nature of the economic outlay was not before the Tax Court. The Tax Court is *AFFIRMED*.

90 T. C. No. 16

UNITED STATES TAX COURT

ESTATE OF DANIEL LEAVITT, DECEASED, CHARLES D. FOX, III, EXECUTOR, AND ESTATE OF EVELYN M. LEAVITT, DECEASED, CHARLES D. FOX, III, EXECUTOR, ET AL.,[1] Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 32041-84, 36453-84, 36454-84, 36455-84. Filed February 10, 1988.

Ps were shareholders in V, an electing small business corporation under subchapter S of the Internal Revenue Code. Ps guaranteed a loan issued by a bank to V. At the time the loan was made, V's liabilities exceeded its assets, and V was unable to meet its cash flow requirements. The loan was issued by the bank only because of Ps' financial strength. However, all payments of principal and interest on the loan were made by V.

Held, absent an economic outlay by Ps, Ps' guarantees of the loan do not increase their basis in their stock in V. *Brown v. Commissioner,* 706 F.2d 755 (6th Cir. 1983), affg. T.C. Memo. 1981-608, and *Calcutt v. Commissioner,* 84 T.C. 716 (1985), followed. *Selfe v. United States,* 778 F.2d

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[1] Cases of the following petitioners are consolidated herewith: Anthony D. and Marjorie F. Cuzzocrea, docket No. 36453-84; Valley Pathology Associates, Inc., docket No. 36454-84; and Estate of Wolfgang A. Wirth, Deceased, Dominion Trust Company, Executor, and Verla J. Wirth, docket No. 36455-84.

769 (11th Cir. 1985), explained. *In re Lane*, 742 F.2d 1311 (11th Cir. 1984), distinguished.

Dianne E. H. Wilcox, for the petitioners.

Stephen M. Friedberg, for the respondent.

OPINION

NIMS, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax as follows:

Docket No.	*Taxable Year Ended*	*Deficiency*
32041-84	December 31, 1979	$ 4,767.77
	December 31, 1980	1,577.06
36453-84	December 31, 1979	3,031.29
	December 31, 1980	16,472.46
	December 31, 1981	13,919.88
36454-84	June 30, 1980	901.00
	June 30, 1981	1,041.00
	June 30, 1982	1,252.00
36455-84	December 31, 1979	1,320.98
	December 31, 1980	1,495.88
	December 31, 1981	2,298.86

These cases were consolidated for trial, briefing and opinion pursuant to Rule 141(a).[2] After concessions and stipulations,[3] the only issue for decision is whether a

[2] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code in effect during the years in issue.

[3] The parties stipulated that this Court's resolution of the issues presented in *Estate of Anthony Gacek, Deceased, Charles D. Fox, III, Executor, et al. v. Commissioner of Internal Revenue*,

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shareholder's guarantee of the debt of an electing small business corporation under subchapter S of the internal Revenue Code increases the shareholder's basis in his stock in the corporation.

All the facts have been stipulated. The stipulations of fact and attached exhibits are incorporated herein by this reference.

At the time the petitions in these cases were filed, Charles D. Fox, III, Anthony D. Cuzzocrea and Marjorie F. Cuzzocrea resided in Roanoke, Virginia.[4] Daniel and Evelyn Leavitt, whose estates are petitioners in docket No. 32041-84, filed a joint Federal income tax return for the taxable year 1979.[5] Anthony D. Cuzzocrea and Marjorie F. Cuzzocrea filed joint Federal income tax returns for the taxable years 1979, 1980 and 1981.

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docket Nos. 17890-81, 17891-81, 17892-81, 17893-81, 10059-82, 10060-82, 10061-82, 10062-82 and 458-84, will control several of the issues in these consolidated cases. Since the time of the parties' agreement, those issues have been decided. See *Estate of Gacek v. Commissioner,* T.C. Memo. 1987-349. After further concessions by the parties, no issues remain with respect to docket Nos. 36454-84 and 36455-84 or the 1980 year in docket No. 32041-84.

[4] At the time the petitions in docket Nos. 36454-84 and 36455-84 were filed, Verla J. Wirth resided in Salem, Virginia, and Valley Pathology Associates, Inc., and Dominion Trust Company had their principal offices in Roanoke, Virginia. However, no issues remain for consideration in docket Nos. 36454-84 and 36455-84. See n.3, *supra.*

[5] Evelyn M. Leavitt, on behalf of herself and her deceased husband, filed a joint Federal income tax return for 1980. However, no issues relating to this return are before the Court. See n.3, *supra.*

VAFLA Corporation (hereinafter referred to as the corporation), was an electing small business corporation under subchapter S during the years in issue and was incorporated in February, 1979, to acquire and operate the Six-Gun Territory Amusement Park near Tampa, Florida. The initial issue of the corporation's capital stock took place in March, 1979, and consisted of 100,000 shares. Daniel Leavitt and Anthony D. Cuzzocrea each paid $10,000 cash for their shares on or before September 30, 1979.

The first taxable year of the corporation consisted of seven months and ended on September 30, 1979. As of September 30, 1979, the corporation had suffered a net operating loss of $265,566.47 and had a retained earnings deficit of $345,370.20. During its second taxable year ending September 30, 1980, the corporation suffered a net operating loss of $482,181.22 and had a retained earnings deficit of $1,093,383.56. During its third taxable year ending September 30, 1981, the corporation suffered a net operating loss of $475,175.70 and had a retained earnings deficit of $1,908,680.22.

From August 2, 1979, through August 27, 1979, Anthony D. Cuzzocrea and Daniel Leavitt, as well as other shareholders, signed guarantee agreements whereby each agreed to be jointly and severally liable for all indebtedness of the corporation to the Bank of Virginia. All the guarantees to the Bank of Virginia were unlimited except the guarantee of Anthony D. Cuzzocrea which was limited to $300,000.

The corporation borrowed $300,000 from the Bank of Virginia for which it issued a promissory note to the bank

dated September 12, 1979. The purpose of the loan was to fund VAFLA's existing and anticipated operating deficits.

At the time the loan was made, the corporation's liabilities exceeded its assets, and the corporation had so little available cash that it could not meet its cash flow requirements. Virtually all of the corporation's assets were encumbered as collateral for a purchase money indebtedness of approximately $1 million to National Service Industries, Inc. In processing the loan, the Bank of Virginia was provided a statement of income for the corporation for its first three months of operation during which the corporation experienced a loss of $142,410.16, resulting in a negative net worth of $82,410.16 as of May 31, 1979.

Seven of the corporation's shareholders agreed to guarantee the $300,000 loan personally. According to the financial statements submitted to the bank, these shareholders had an aggregate net worth of $3,407,286 and immediate liquidity (cash and securities) of $382,542. The loan was approved only because of the financial strength of the guarantors.

The Bank of Virginia loan was consistently shown on the corporation's financial statements and tax returns for its fiscal years ending 1979, 1980 and 1981, as a loan from shareholders. However, during those years, the corporation made the following principal payments to the Bank of Virginia:

December 26, 1979	$10,000
July 15, 1980	10,000
January 6, 1981	10,000

All interest payments were also made by the corporation. None of the payments by the corporation on the principal or the interest of the loan were reported by the corporation or petitioners as constructive dividends.

Daniel and Evelyn M. Leavitt deducted a loss of $13,808 attributable to the corporation on their 1979 joint Federal income tax return. Respondent disallowed $3,808 of this deduction. Anthony D. and Marjorie F. Cuzzocrea deducted losses of $13,808, $29,921 and $22,746 attributable to the corporation on their 1979, 1980 and 1981 joint Federal income tax returns, respectively. Respondent disallowed all of these deductions in excess of $10,000.

Respondent takes the position that shareholders Daniel Leavitt and Anthony D. Cuzzocrea may not deduct losses attributable to the corporation in excess of their initial basis in their shares of the corporation. Petitioners maintain that their guarantees of the $300,000 loan to the corporation from the Bank of Virginia increased their basis in their stock sufficiently to allow deductions for their proportionate shares of losses attributable to the corporation during the years in issue.

Former section 1374,[6] as in effect during the years in issue, permitted a shareholder in a subchapter S corporation

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[6] Former section 1374, as in effect during the years in issue provided:

CORPORATION NET OPERATING LOSS
ALLOWED TO SHAREHOLDERS

Sec. 1374 [1954 Code]. (a) GENERAL RULE. – A net operating loss of an electing small business

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to deduct his portion of the corporation's net operating loss from his gross income. Former section 1374(c) limited the

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corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) ALLOWANCE OF DEDUCTION. – Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)). The deduction allowed by this subsection shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

(c) DETERMINATION OF SHAREHOLDER'S PORTION. –

(1) IN GENERAL. – For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this

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amount of the deduction to the sum of (1) the adjusted basis of the shareholder's stock in the corporation and (2)

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paragraph, a shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

(2) LIMITATION. – A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of –

(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the

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the adjusted basis of any indebtedness of the corporation to the shareholder.

The corporation sustained losses for the taxable years 1979, 1980 and 1981. Before the guarantee transaction, petitioners Daniel Leavitt and Anthony D. Cuzzocrea each had an adjusted basis in their stock in the corporation of $10,000. We must determine whether petitioners' guarantee of the $300,000 loan from the Bank of Virginia to the corporation increased the basis in petitioners' stock in the corporation.

It is well settled that:

> the fact that shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of section 1374(c)(2)(B). No form of indirect borrowing, be it guaranty, surety, accommodation, comaking

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shareholder was a shareholder in the corporation).

In 1982 Congress revised the rules pertaining to subchapter S corporations in the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669. The revisions in the 1982 Act do not apply in this case, however, because they apply only to taxable years beginning after December 31, 1982. Section 6(a), Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669, 1697 (1982). The taxable years in this case are 1979, 1980 and 1981.

We note, however, that the limitations provided in former section 1374(c)(2) were reenacted by section 2 of the Subchapter S Revision Act of 1982 in section 1366(d)(1). Section 1366(d)(1) is currently in effect.

> or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation. * * * [*Raynor v. Commissioner,* 50 T.C. 762, 770-771 (1968).]

See also *Putnam v. Commissioner,* 352 U.S. 82 (1956); *Underwood v. Commissioner,* 535 F.2d 309 (5th Cir. 1976), affg. 63 T.C. 468 (1975); *Perry v. Commissioner,* 47 T.C. 159, affd. 392 F.2d 458 (8th Cir. 1968); *Wheat v. United States,* 353 F.Supp. 720 (S.D. Tex. 1973); *Neal v. United States,* 313 F.Supp. 393 (C.D. Cal. 1970).

In the instant case petitioners have never been called upon to pay any of the loan that they guaranteed. Accordingly, the guarantees that petitioners executed do not increase any indebtedness of the corporation to them.

Nevertheless, petitioners ask us to view the guarantee transactions as constructive loans from the banks to petitioners and, in turn, contributions of those same funds by petitioners to the capital of the corporation. In other words, petitioners contend that their guarantees of the $300,000 loan from the Bank of Virginia to the corporation should increase their basis in the stock of the corporation. We disagree.

Under former section 1374(c)(2) corporate debts to third parties guaranteed by the shareholder, whether collateralized or not, do not lead to an increase in the shareholder's basis in his subchapter S corporation stock. To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay or a realization of income on the part of the shareholder. *Brown v. Commissioner,* 706 F.2d 755 (6th Cir. 1983), affg. T.C.

Memo. 1981-608; *Calcutt v. Commissioner,* 84 T.C. 716, 720 (1985).

The term "basis," for purposes of section 1374(c), is defined in section 1012.[7] *Borg v. Commissioner,* 50 T.C. 257, 263 (1968). Section 1012 provides the general rule that the "basis of property shall be the cost of such property." Section 1.1012-1(a), Income Tax Regs., defines "cost" to mean the "amount paid" for property "in cash or other property." Because petitioners' guarantees in this case do not constitute cash or other property, they cannot be included in the basis of petitioners' stock in the corporation.

In *Borg v. Commissioner, supra,* an electing small business corporation owed one of its shareholders unpaid salary for his performance of services as evidenced by notes from the corporation to the shareholder. The shareholder did not report any part of the unpaid salary as income in his returns. The shareholder in *Borg* argued that the notes for the unpaid salary increased his basis in the indebtedness of the corporation to him. We held that because the shareholder had incurred no cost in connection with the notes, he had no basis in the notes and

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[7] Section 1012 provides:

> The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

therefore there was no addition to the adjusted basis of the indebtedness of the corporation to the shareholder. We explained:

> [C]ost for the purposes of the Code ordinarily means cost to the taxpayer. *Detroit Edison Co. v. Commissioner,* 319 U.S. 98 (1943). Where a taxpayer has not previously reported, recognized, or even *realized* income, it cannot be said that he has a basis for a note evidencing his right to receive such income at some time in the future. That petitioner Joe E. Borg performed valuable services for Borg Steel is undeniable; however, the performance of services, involving neither the realization of taxable income nor a capital outlay, is not the kind of cost that would be shown in a cash receipts and disbursements system of income accounting. See, e.g., *Pounds v. United States,* 372 F.2d 342, 351-352 (C.A. 5, 1967); *Alsop v. Commissioner,* 290 F.2d 726 (C.A. 2, 1961), affirming on other grounds 34 T.C. 606 (1960); *Ernest W. Brown, Inc.,* 28 T.C. 682 (1957), affirmed per curiam 258 F.2d 829 (C.A. 2, 1958). Since the services performed by petitioner Joe E. Borg had no cost within the meaning of section 1012, his notes for unpaid salary had a basis of zero and, therefore, added nothing to the adjusted basis for indebtedness for the purpose of computing the section 1374(c)(2) limitation on net operating loss deductions. [*Borg v. Commissioner,* 50 T.C. at 263; emphasis in original.]

In this case petitioners' guarantees did not require any capital outlay on their part during the years in issue. Without capital outlay or a realization of income, as required by *Borg,* petitioners cannot increase their adjusted basis in their stock in the corporation. Nor can it of course be said that the guarantees in question were corporate debt obligations to petitioners which acquired a

basis resulting from any capital outlays by petitioners. Petitioners ask, however, that we ignore the form of the transaction, i.e., a loan from the Bank of Virginia to the corporation that was guaranteed by its shareholders, and find that the bank actually loaned the money to the shareholder-guarantors who then advanced the proceeds of the loan as a contribution to the capital of the corporation. We decline to adopt petitioners' view of the transaction.

The Bank of Virginia loaned the money to the corporation and not to petitioners. The proceeds of the loan were to be used in the operation of the corporation's business. Petitioners submitted no evidence that they were free to dispose of the proceeds of the loan as they wished. Nor were the payments on the loan reported as constructive dividends on the corporation's Federal income tax returns or on petitioners' Federal income tax returns during the years in issue. Accordingly, we find that the transaction was in fact a loan by the bank to the corporation guaranteed by the shareholders.

Nevertheless, petitioners ask that we apply traditional debt-equity principles[8] in determining the nature

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[8] The debt-equity analysis usually is applied to guaranteed debts in cases involving subchapter C corporations in which respondent argues that advances made in the form of a guaranteed debt are in substance capital contributions. See, e.g., *John Kelly Co. v. Commissioner*, 326 U.S. 521 (1946); *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976); *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), affg. T.C. Memo. 1970-182; *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967); *Smyers v. Commissioner*, 57

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of the transaction in this case. Petitioners maintain that because the corporation was insolvent at the time the loan was made and because the bank would not have

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T.C. 189 (1971); *Santa Anita Consolidated, Inc. v. Commissioner,* 50 T.C. 536 (1968); *Kavich v. United States,* 507 F.Supp. 1339 (D. Neb. 1981). The courts generally consider the following factors in determining whether a debt transaction should be regarded as a contribution to equity:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; (11) the ability of the corporation to obtain loans from outside lending institutions [footnote omitted]. [*Plantation Patterns, Inc. v. Commissioner,* 462 F.2d at 718-719.]

O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 125-26 (9th Cir. 1960), affg. a Memorandum Opinion of this Court.

In addition, courts take into consideration factors such as the extent to which the advance was used to acquire capital assets and the failure of the debtor to repay on the due date or to seek a postponement. *In re Lane,* 742 F.2d 1311, 1315 (11th Cir. 1984); *Estate of Mixon v. United States,* 464 F.2d 394, 402 (5th Cir. 1972); *Fin Hay Realty Co. v. United States,* 398 F.2d 694, 696 (3d Cir. 1968).

See also section 385, which provides as follows:

SEC. 385. TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS.

advanced the funds to the corporation without the shareholders' guarantees, the loan was in fact a loan from the bank to the shareholders who then advanced the

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(a) AUTHORITY TO PRESCRIBE REGULATIONS. – The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.

(b) FACTORS. – The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

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proceeds of the loan as a contribution to the capital of the corporation. We decline to adopt traditional debt-equity principles in this case.

Petitioners' reliance on *Blum v. Commissioner,* 59 T.C. 436 (1972), is misplaced. In *Blum* the taxpayer, a shareholder in an electing small business corporation under subchapter S, also asked us to apply traditional debt-equity principles and treat his guarantee of a loan from a bank to the corporation as an indirect capital contribution. We declined to decide the issue as to the applicability of debt-equity principles because the taxpayer had failed his burden of proving that the bank in substance had loaned the funds to the taxpayer and not to the corporation. *Blum v. Commissioner,* 59 T.C. at 439 n.4.

Petitioners' reliance on *In re Breit,* 460 F.Supp. 873 (E.D. Va. 1978), is also misplaced. The facts in *Breit* were similar to the facts in *Blum.* The taxpayers in *Breit* raised the same argument as was raised in *Blum* that their guarantees of loans from a bank to their subchapter S corporation were actually loans from the bank to the

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Congress enacted section 385 in the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487, 613. Proposed regulations under this section had been issued but were withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. At the present time there are no regulations implementing the provisions of section 385.

In making the debt-equity determination, the Court must decide each case on its own facts, and no one standard is controlling. *Plantation Patterns, Inc. v. Commissioner, supra; Santa Anita Consolidated, Inc. v. Commissioner, supra.*

shareholders and, in turn, contributions by the shareholders to the capital of the corporation. The court held in *Breit*, as in *Blum*, that the taxpayer-shareholders had failed their burden of proving that the loans that they had guaranteed were advanced to them rather than to the corporation. The court also considered and rejected various other variations on this theme, e.g., that the subchapter S corporation was the shareholder's alter ego, also intended to show that the bank loans were actually made to the shareholder.

In *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), the Eleventh Circuit applied a debt-equity analysis and held that a shareholder's guarantee of a loan made to a subchapter S corporation may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor. We respectfully disagree with the Eleventh Circuit and hold that a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder.

The *Selfe* opinion was based primarily on *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), affg. T.C. Memo. 1970-182, in which the Fifth Circuit affirmed as not clearly erroneous a finding by this Court that a transaction structured as a loan by an independent third party to a corporation, and guaranteed by a shareholder, was in substance a loan to the shareholder followed by his contribution of the loan proceeds to the corporation, and that as a result the corporation's payments of principal and interest on the debt constituted constructive dividends to the shareholder.

However, the corporation in *Plantation Patterns* was a subchapter C corporation. We decline to apply the debt-equity analysis used in *Plantation Patterns* to the guarantee of a loan to a subchapter S corporation. Congress has promulgated a set of rules designed to limit the amount of deductions allowable to a shareholder of a subchapter S corporation to the amount he has actually invested in the corporation and the amounts of income from the corporation included in the shareholder's gross income. See former sections 1374(c) and 1376.[9] The report of the Committee on Finance of the Senate underscores Congress's purpose as follows:

> The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under section 1374(c)(2) to the adjusted basis of the shareholder's *investment* in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder. * * * [S. Rept. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 1141. Emphasis added.]

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[9] Former section 1376, as in effect during the years in issue, provided:

> ADJUSTMENTS TO BASIS OF STOCK OF, AND INDEBTEDNESS OWING, SHAREHOLDERS
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> Sec. 1376 [1954 Code]. (a) INCREASE IN BASIS OF STOCK FOR AMOUNTS TREATED AS DIVIDENDS. – The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section

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As we construed this language in *Perry v. Commissioner,* 54 T.C. 1293, 1296 (1970), the use of the word "investment" reveals an intent, on the part of the committees, to limit the applicability of section 1374(c)(2) to the actual economic outlay of the shareholder in question.

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1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

(b) REDUCTION IN BASIS OF STOCK AND INDEBTEDNESS FOR SHAREHOLDER'S PORTION OF CORPORATION NET OPERATING LOSS. –

(1) REDUCTION IN BASIS OF STOCK. – The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

(2) REDUCTION IN BASIS OF INDEBTEDNESS. – The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the

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See also *Pike v. Commissioner*, 78 T.C. 822, 839-840 (1982), affd. without published opinion 732 F.2d 164 (9th Cir. 1984). To allow petitioners to increase the basis of their stock without a capital outlay or a realization of income would provide them a means of avoiding these limitations. See also *Brown v. Commissioner*, 706 F.2d at 756 (absent an economic outlay requirement for obtaining an increase in basis, subchapter S shareholders could readily skirt the limitation embodied in section 1374(c) and thereby erect a tax shelter that Congress never intended to create).

In *Selfe* the court also relied on *In re Lane*, 742 F.2d 1311 (11th Cir. 1984), in which the Eleventh Circuit applied a debt-equity analysis and held that funds advanced to a subchapter S corporation by a shareholder and payments made by the shareholder as guarantor of corporate obligations to institutional lenders were capital contributions rather than loans from the shareholder to the corporation. In *Lane* the shareholder had actually paid the amounts he had guaranteed and, therefore, the amounts he paid could be considered a contribution to capital. In this case petitioners have not paid any of the

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> adjusted basis of the stock of such corporation held by the shareholder.

In 1982 Congress revised the rules pertaining to subchapter S corporations in the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669. The provisions of the revising act apply to the taxable years beginning after December 31, 1982, and therefore do not apply in this case. See n.6, *supra*.

loans they guaranteed and, therefore, have contributed nothing to the capital of the corporation.

Petitioners' reliance on section 1.385-9, Proposed Income Tax Regs., is also misplaced. The proposed regulation was withdrawn in 1983. T.D. 7920, 1983-2 C.B. 69. Proposed regulations are only preliminary proposals; they are not binding on respondent or on the Court. *Garvey, Inc. v. United States,* 1 Cl.Ct. 108 (1983), affd. 726 F.2d 1569 (Fed. Cir. 1984). Moreover, section 1.385-9, Proposed Income Tax Regs., was drafted in connection with section 385 which is a part of subchapter C of the Internal Revenue Code. Because we hold that the debt-equity analysis does not apply to guaranteed loans to subchapter S corporations for which the shareholder has incurred no cost, the proposed regulation is not relevant in this case.

To reflect the foregoing.

Decisions will be entered

under Rule 155.

Reviewed by the Court.

STERRETT, CHABOT, PARKER, WHITAKER, KORNER, SHIELDS, HAMBLEN, COHEN, CLAPP, JACOBS, GERBER, WRIGHT, PARR, WELLS, and RUWE, *JJ.*, agree with the majority opinion.

SWIFT and WHALEN, *JJ.*, concur in the result only.

WILLIAMS, *J.*, concurring: I agree with the result of the majority opinion and concur that petitioners should be stuck with the form of the transaction they chose. The majority opinion, however, unnecessarily rejects the reasoning of *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985). *Selfe* involved a sole shareholder's guarantee, and because the bank looked to that shareholder for repayment, the form of the transaction had no tax significance. The shareholder could be properly viewed as in effect contributing the proceeds of the loan to the corporation.

Unlike *Selfe*, this case involves a guarantee by multiple shareholders. In the case of the sole shareholder's guarantee of a loan to his financially strapped corporation, no doubt exists about who the bank is really looking to for repayment of the loan. In the case of multiple shareholders' guarantees, however, doubt about who is liable on the loan persists, except to the extent that payments are made on the loan. In this case, even if petitioners have shown that the bank looked to them as a group, no rationale exists for allocating the proceeds of the loan as deemed contributions to capital among the shareholders. Each is jointly and severally liable for the amount of the loan (except for Mr. Cuzzocrea whose liability is capped at $300,000.00). As a result of this

ambiguous liability, if a shareholder's basis in his stock turns on whom the bank looks to for repayment, each shareholder could rightly claim to have contributed the entire proceeds of the loan because each shareholder could have properly argued that the bank could look only to him for repayment. The result of such claims would be an unwarranted multiplication of basis which is contrary to the purpose and intent of sections 1012 and 1374 and which violates the integrity of the tax law. This unwarranted multiplication of basis cannot occur for a sole shareholder's guarantee.

I believe there are circumstances, limited to cases involving the sole shareholder, where the *Selfe* rationale can be correctly applied. We do not need to reject *Selfe* in this case, and I view the majority's attempt to do so as dicta.

FAY, *J.*, dissenting: The majority opinion holds that petitioners' guarantees do not increase the amount of their section 1374(c)(2) limitations. The majority opinion errs by not recognizing the applicability of traditional debt-equity principles in determining the Federal tax effect of petitioners' guarantees and by not recognizing the existence and presence of the type of economic outlay proven by petitioners. Before addressing these errors, I will first discuss the distinctions between section 1374(c)(2)(A) and section 1374(c)(2)(B), distinctions which the majority does not fully address.

The portion of the net operating loss of an electing small business corporation which may be deducted by a

shareholder is limited to the sum of the amount determined in section 1374(c)(2)(A) and the amount determined in section 1374(c)(2)(B). Section 1374(c)(2)(A) pertains to the adjusted basis in stock of the electing small business corporation. Section 1374(c)(2)(B) pertains to the adjusted basis of any indebtedness of the electing small business corporation to the shareholder.

Though petitioners clearly and specifically argue that section 1374(c)(2)(B) is not applicable here, the majority opinion begins its legal analysis by quoting from *Raynor v. Commissioner*, 50 T.C. 762, 770-771 (1968):

> No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to *indebtedness from the corporation to the shareholders* until and unless the shareholders pay part or all of the obligation. [Emphasis added.]

Majority slip op. at 9. I fully agree with this settled statement of the law, but view it as irrelevant to the issue presented. Petitioners are not arguing that their guarantees increased the amount of "any indebtedness of the corporation to the shareholder," as used in section 1374(c)(2)(B) and interpreted in *Raynor v. Commissioner, supra.* Rather, petitioners contend that since the Bank of Virginia looked primarily to petitioners and the other shareholder/guarantors, not VAFLA, for repayment of the $300,000, in substance petitioners and the other shareholder/guarantors borrowed the $300,000 from the Bank of Virginia and made a capital contribution of such amount to VAFLA. Accordingly, petitioners are arguing that they are entitled to an increase in their "adjusted

basis *** of the shareholder's stock in the electing small business corporation" as used in section 1374(c)(2)(A).

That the majority did not recognize the distinctions between section 1374(c)(2)(A) and section 1374(c)(2)(B) is illustrated by the majority's quote from *Borg v. Commissioner*, 50 T.C. 257, 263 (1968), and the conclusion drawn therefrom. The majority opinion quotes a passage from *Borg*, the final sentence of which is:

> Since the services performed by petitioner Joe E. Borg had no cost within the meaning of section 1012, his notes for unpaid salary had a basis of zero and, therefore, added nothing to the *adjusted basis for indebtedness* for the purpose of computing the section 1374(c)(2) limitation on net operating loss deductions. [Emphasis added.]

Majority slip op. at 12. From this quote, which is no more relevant to the issue presented than the quote from *Raynor v. Commissioner, supra*, the majority makes the quantum leap without explanation to the conclusion that:

> Without capital outlay or a realization of income, as required by *Borg*, petitioners cannot increase their *adjusted basis in their stock in the corporation*. [Emphasis added.]

Majority slip op. at 12.

The majority, by not recognizing the distinctions between section 1374(c)(2)(A) and section 1374(c)(2)(B), was prevented from weeding out irrelevant cases and properly focusing on the issue presented. Further, petitioners herein have recognized, as has this Court, that shareholder-guaranteed corporate debt cannot be characterized as an indebtedness of the corporation to the

shareholder.[1] I will now address the errors of the majority opinion.

I. Debt-equity principles are applicable in determining whether a shareholder-guaranteed corporate debt should be characterized as a capital contribution.

That a shareholder-guaranteed corporate debt can be characterized for Federal tax purposes as a capital contribution is hardly a novel legal theory. This legal theory has been considered in at least 20 opinions.[2] Almost

[1] As will be seen below, whether a shareholder-guaranteed corporate debt is in substance a shareholder debt turns on whether an analysis of traditional debt-equity factors reveals the presence of more equity than debt factors. Whether more equity factors are present, the shareholder-guaranteed corporate debt is characterized as shareholder debt. The deemed advance of the loan proceeds from the shareholder to the corporation must, of course, be characterized as a capital contribution, rather than a loan, because more equity than debt factors are present. As a capital contribution, the shareholder receives an increase in the basis of stock, see section 1374(c)(2)(A), and not an increase in any indebtedness of the corporation to the shareholder, see section 1374(c)(2)(B). See also *Bader v. Commissioner*, T.C. Memo. 1987-30.

[2] See, *Blum v. Commissioner*, 59 T.C. 436, 439-440 (1972), *Smyers v. Commissioner*, 57 T.C. 189, 198 (1971); *Santa Anita Consolidated, Inc. v. Commissioner*, 50 T.C. 536, 550 (1968); *J.A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273, 1290 n.2 (1958); *Schneiderman v. Commissioner*, T.C. Memo. 1987-551; *Gurda v. Commissioner*, T.C. Memo. 1987-394; *Bader v. Commissioner*, T.C. Memo. 1987-30; *Blackman v. Commissioner*, T.C. Memo. 1981-244; *Albert v. Commissioner*, T.C. Memo. 1980-567; *LaStaiti v. Commissioner*, T.C. Memo. 1980-547; *Selfe v. United States*, 778 F.2d 769, 774 (11th Cir. 1985); *In re Lane*, 742 F.2d 1311,

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invariably, these opinions consider traditional debt-equity principles in determining whether to characterize a guaranteed debt as a capital contribution.[3] Despite this heavy weight of authority, the majority opinion "decline[s] to adopt traditional debt-equity principles in this case." Majority slip op. at 15. The majority opinion bases its declination to apply traditional debt-equity principles on its erroneous interpretation of *Blum v. Commissioner*, 59 T.C. 436 (1972), and on its unsound refusal to follow *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985).

The majority opinion states that in *Blum*

> [the Tax Court] declined to decide the issue as to the applicability of debt-equity principles because the taxpayer had failed his burden of

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1319-1320 (11th Cir. 1984); *Casco Bank & Trust Co. v. United States*, 544 F.2d 528, 534-535 (1st Cir. 1976); *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 722-724 (5th Cir. 1972), affg. T.C. Memo. 1970-182; *Murphy Logging Co. v. United States*, 378 F.2d 222, 224 (9th Cir. 1967); *Kavich v. United States*, 507 F. Supp. 1339, 1342 (D. Neb. 1981); *In re Breit*, 460 F. Supp. 873, 875 (E.D. Va. 1978); *Ackerson v. United States*, 277 F. Supp 475, 477 (W.D. Ky. 1967); and *Fors Farms, Inc. v. Commissioner*, an unreported case (W.D. Wash. 1966) (66-1 U.S.T.C. par. 9206, 17 A.F.T.R.2d 222). See also *Ellisberg v. Commissioner*, 9 T.C. 463 (1947) and *Pierce v. Commissioner*, 41 B.T.A. 1261 (1940), wherein the issue was whether a guarantee could be characterized as a gift.

[3] See *Blum v. Commissioner, supra; Smyers v. Commissioner, supra; Santa Anita Consolidated, Inc. v. Commissioner, supra; La Staiti v. Commissioner, supra; Selfe v. United States, supra; In re Lane, supra; Casco Bank & Trust Co. v. United States, supra; Plantation Patterns Inc. v. Commissioner, supra; Murphy Logging Co. v. United States, supra; Kavich v. United States, supra; In re Breit, supra; Ackerson v. United States, supra;* and *Fors Farms, Inc. v. Commissioner, supra.*

> proving that the bank in substance had loaned the funds to the taxpayer and not to the corporation. *Blum v. Commissioner*, 59 T.C. at 439, n.4.

Majority slip op. at 16. The majority opinion misstates the holding in *Blum* wherein the Court stated:

> As we stated in *Santa Anita Consolidated, Inc.* [*v. Commissioner*, 50 T.C. 536, 550 (1968)], "Whether such debt [guaranteed debt] is to be treated as an indirect capital contribution must be resolved by an investigation of the facts in light of traditional debt-equity principles." In the present fully stipulated case, after applying many of those traditional principles, we find that petitioner simply has not carried his burden of proof and has not convinced this Court that the guaranteed loans should properly be characterized as equity investments. [Bracketed phrase, "guaranteed debt," in original.]

Blum v. Commissioner, supra at 439-440. Contrary to the majority opinion, the Tax Court did not decline to apply traditional debt-equity principles because the taxpayer failed in his burden of proof, but rather applied traditional debt-equity principles to determine that the taxpayer failed in his burden of proof. The distinction is more than merely semantical. As will be seen below, petitioners herein have carried their burden of proof. Accordingly, a proper interpretation of *Blum* and a proper application of traditional debt-equity principles, as mandated by *Blum*, would lead to a result contrary to the result reached by the majority.[4]

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[4] The majority opinion attempts to draw undue weight from note 4 in *Blum v. Commissioner, supra* at 439, which provides:

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In *Selfe v. United States, supra,* the Eleventh Circuit held that traditional debt-equity principles are applicable in determining whether a shareholder-guaranteed subchapter-S corporate debt should be recharacterized as a capital contribution.[5] The majority disagreed with the Eleventh Circuit and refused to allow *Selfe* because *Selfe* relied on *Plantation Patterns, Inc. v. Commissioner,* 462 F.2d 712 (5th Cir. 1972), affg. T.C. Memo. 1970-182, and *In re Lane,* 742 F.2d 1311 (11th Cir. 1984).

Plantation Patterns held that corporate deductions for interest paid on shareholder-guaranteed corporate debts were improper and the principal payments[6] made on

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> The respondent has argued that the entire equity-contribution argument espoused by petitioner is inimical to the subch. S area. Because of our holding that the facts do not warrant the applicability of this doctrine to the present case we will not consider this rather fascinating question.

It is clear that "doctrine" as used in the note does not mean "the applicability of debt-equity principles to determine if shareholder-guaranteed debt should be characterized as a capital contribution," but rather means "characterization of a shareholder-guaranteed corporate debt as a capital contribution after evaluation of traditional debt-equity principles." Consider the Court's textual statement, "after applying many of those traditional principles, we find ***." *Blum v. Commissioner, supra* at 439, quoted herein, *supra* at 5. Note 4 in *Blum* was improperly relied on by the majority.

[5] J. Eustice & J. Kuntz in Taxation of S Corporations, par 10.03[2][i], n.184 (Rev. Ed. 2d Supp. 1987), refer to *Selfe v. United States, supra,* as a "well reasoned opinion."

[6] See n.24, *infra.*

such debts were taxable income to the guaranteeing shareholder because such debts were in substance capital contributions. The majority opinion determined that *Selfe*'s reliance on *Plantation Patterns* is inappropriate because:

> the corporation in *Plantation Patterns* was a subchapter C corporation. We decline to apply the debt-equity analysis used in *Plantation Patterns* to the guarantee of a loan to a subchapter S corporation.

Majority slip op. at 17.

This determination by the majority opinion not to apply subchapter C precedent to subchapter S corporations evinces a lack of understanding as to the purpose of applying traditional debt-equity principles to a given situation. Traditional debt-equity principles are applied to determine the substance of a transaction. After making such determination, the substance of the transaction, not the form, is evaluated for Federal income tax purposes. See *Diedrich v. Commissioner*, 457 U.S. 191, 195 (1982) (substance not form controls). Determining the substance of a transaction is the initial step in resolving a given issue and transcends the legal analysis. The substance of a particular transaction is fixed for that transaction. It does not vary depending upon the legal analysis to which it will be subjected. If a guarantee of a corporate debt is in substance a capital contribution, then it is a capital contribution regardless of whether the corporation is a subchapter S corporation or a subchapter C corporation. That the substance of the transaction transcends the legal analysis is illustrated in *Plantation Patterns*. Interest is

deductible by subchapter C and subchapter S corporations. Sec. 163. The disallowance of the interest deduction in *Plantation Patterns* was independent of the corporation's status as a subchapter C or subchapter S corporation.[7]

The majority attempts to gain support by quoting the following passage from a Senate Finance Committee report:

> The amount of the net operating loss apportioned to any shareholder *** is limited under section 1374(c)(2) to the adjusted basis of the shareholder's investment in the corporation; that is, to *the adjusted basis of the stock in the corporation owned by the shareholder* and the adjusted basis of any indebtedness of the corporation to the shareholder. [Emphasis added.]

S. Rept. No. 1983, 85th Cong. 2nd Sess. 220 (1958), 1958-3 C.B. 922, 1141. See majority slip op. at 19. Where the guaranteed loan is treated in substance as a capital contribution, the guaranteeing shareholder's adjusted basis in the stock of the corporation will be increased,[8] and so

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[7] Consider the following hypothetical:

> Corporation A, a C corporation, pays "interest" on a shareholder-guaranteed debt to a bank. Respondent determines and this Court agrees that because the shareholder-guaranteed debt is in substance a capital contribution, the interest deduction is not allowable. Later Corporation A becomes an S corporation. Would the "interest" payments now be deductible under the majority opinion's analysis?

[8] *Frantz v. Commissioner*, 83 T.C. 162, 172 (1984), affd. 784 F.2d 119 (2d Cir. 1986).

would the shareholder's "investment in the corporation," as that phrase is used by the Senate Finance Committee. Accordingly, the Senate Finance Committee's report *could* be read as an expression of congressional intent to allow an increase in the section 1374(c)(2) limitation where a shareholder-guaranteed corporate debt is in substance a capital contribution. Actually though the Senate Finance Committee report cannot fairly be read as an expression of congressional intent either to allow or disallow an increase in the amount of the section 1374(c)(2) limitation where a shareholder-guaranteed corporate debt is in substance a capital contribution.

Whatever sin was committed by the Eleventh Circuit in relying on subchapter C precedent in a subchapter S case, this Court has committed on innumerable occasions.[9] We have even stated in *Blum v. Commissioner, supra* at 439:

> [R]egardless of the context in which a debt-equity determination arises, we can see no distinction in principle between the case before us [relating to a subchapter S corporation] and the numerous cases in the area which serve as judicial guideposts [relating to subchapter C corporations]. [Citation and footnote reference omitted.]

Further, respondent is not here arguing that subchapter C precedent is inapplicable to subchapter S cases. It is

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[9] Citation to subchapter S cases relying on subchapter C precedent would serve no purpose. Suffice it to say that all, or nearly all, subchapter S cases cite subchapter C precedent or subchapter S precedent which relied on subchapter C precedent.

unnecessary for the majority opinion to reach this issue, criticize the Eleventh Circuit for relying on subchapter C precedent in a subchapter S case, while ignoring the innumerable occasions in which this Court has done the same, and directly contradict language in our opinion in *Blum*, where neither party is asking the Court to do so. The Eleventh Circuit's reliance on *Plantation Patterns* is not an appropriate basis for the majority to decline to follow *Selfe*.

The majority opinion also attempts to impugn *Selfe* for its reliance on *In re Lane, supra*. In that case, the taxpayer claimed a bad debt deduction for payments made pursuant to his guarantee of a loan made to a corporation in which he was a shareholder.[10] The Eleventh Circuit considered traditional debt-equity principles and concluded that as of the time of the guarantee, the taxpayer, not the corporation, was the true debtor and that the taxpayer had made a capital contribution of the loan proceeds to the corporation. *In re Lane, supra* at 1320. Payments later made pursuant to the guarantee could not be considered bad debts. The Eleventh Circuit disallowed the claimed deductions. *In re Lane, supra* at 1320.

The majority states,

> In *Lane* the shareholder had actually paid the amounts he had guaranteed and, therefore, the

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[10] The taxpayer in *In re Lane, supra,* did not actually make payments; rather, assets belonging to the taxpayer were sold to satisfy the obligation arising from the guarantee. We see no distinction between the two and analyze *In re Lane, supra,* as if the taxpayer did make payments pursuant to the guarantee.

> amounts he paid *could* be considered a capital contribution. [Emphasis added.]

Majority slip op. at 20. It is true that the taxpayer in *In re Lane* had made payments pursuant to the guarantee. However, the holding in *In re Lane,* which was the basis of *Selfe*'s reliance on *In re Lane,* was that a shareholder-guaranteed corporate debt can, depending on an analysis of traditional debt-equity principles, be characterized as a capital contribution and the analysis of whether the shareholder guaranteed-debt is to be so characterized is made as of the time of the guarantee, not at some later date, e.g., when payment is made pursuant to the guarantee. Accordingly, *In re Lane* was properly relied upon in *Selfe.*[11]

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[11] *In re Lane* was also relied on in *Selfe* for the proposition that the taxpayer as well as the government may question whether a shareholder's advance to a corporation is debt or equity. Neither the majority nor respondent argue that petitioners are precluded from arguing substance over form. In *Selfe v. United States, supra,* the taxpayer was allowed to argue substance over form in claiming that her guarantee of a bank loan to an electing small business corporation in which she was a shareholder increased the amount of her section 1374(c)(2) limitation. The Eleventh Circuit stated:

> Although the question of whether a stockholder's advances to a corporation constitute debt or capital contributions is usually raised by the government, nothing in the Internal Revenue Code or our decisions suggests that the factors used to determine the substantive character of a taxpayer's interest in a corporation are available only to the government. *See In re Lane,* 742 F.2d at 1315; *cf. Peter E. Blum,* 59 T.C.

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The reasons advanced in the majority opinion for not following *Selfe* are not convincing. *Selfe* is on all fours and its holding that traditional debt-equity principles are applicable in determining whether a shareholder-guaranteed corporate debt is in substance a capital contribution should be followed.

The majority, as stated earlier, decided not to apply traditional debt-equity principles to the issue presented. This decision was based on an erroneous interpretation of *Blum* and an unsound refusal to follow *Selfe*. Based on the opinions of this Court and the opinions of the First, Fifth, Ninth, and Eleventh Circuits, traditional debt-equity principles should be applied in determining whether a shareholder-guaranteed corporate debt should be characterized as a capital contribution.

In *Blum v. Commissioner, supra* at 439, in *Smyers v. Commissioner*, 57 T.C. 189, 198 (1971); and in *Santa Anita Consolidated, Inc. v. Commissioner*, 50 T.C. 536, 550 (1968), we stated:

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436, 439 (1972) (principles for resolving debt-equity determinations are consistent regardless of the context in which such determinations arise); *J.A. Maurer, Inc.*, 30 T.C. 1273 (1958). Accordingly, where the nature of a taxpayer's interest in a corporation is in issue, courts may look beyond the form of the interest and investigate the substance of the transaction. These situations present an exception to the general proposition that a shareholder/taxpayer is bound by the form of her transaction. *See Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 795-96 (1975).

Selfe v. United Stated, supra at 774.

> Whether [guaranteed] debt is to be treated as an indirect capital contribution must be resolved by an investigation of the facts in light of traditional debt-equity principles.

In *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976), the First Circuit held, *after applying traditional debt-equity principles*, that a shareholder's agreement to indemnify a bonding company that bonded the shareholder's corporation was in substance a capital contribution. In *Plantation Patterns Inc. v. Commissioner, supra*, the Fifth Circuit held, *after applying traditional debt-equity principles*, that a shareholder's guarantee of a corporate debt was in substance a capital contribution. In *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967), the Ninth Circuit held, *after applying traditional debt-equity principles*, that a shareholder-guaranteed corporate debt was not in substance the shareholders' debt. In *In re Lane, supra*, the Eleventh Circuit held *after applying traditional debt-equity principles*, that a shareholder's guarantee of a corporate debt was in substance a capital contribution. In *Selfe v. United States, supra*, the Eleventh Circuit *held that debt-equity principles should be applied* in determining whether a shareholder-guaranteed corporate debt should be characterized as a shareholder debt.[12] See also *Kavich*

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[12] Appeal in this case lies to the Fourth Circuit. Accordingly we are not required by *Golsen v. Commissioner* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), to follow the opinions in *Casco Bank & Trust Co. v. United States, supra* (1st Circuit); *Plantation Patterns, Inc. v. Commissioner, supra* (5th Circuit); *Murphy Logging Co. v. United States, supra* (9th Circuit); *In re Lane, supra* (11th Circuit); or *Selfe v. United States, supra* (11th Circuit). Some commentators think that the Tax Court

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v. United States, 507 F. Supp 1339 (D. Neb. 1981); *In re Breit,* 460 F. Supp 873 (E.D. Va. 1978); *Ackerson v. United States,* 277 F. Supp 475 (W.D. Ky. 1967); and *Fors Farms, Inc. v. Commissioner,* an unreported case (W.D. Wash. 1966) (66-1 U.S.T.C. par. 9706, 17 A.F.T.R.2d 222). Other than the majority opinion, there exists, to my knowledge, no authority that refuses to apply traditional debt-equity principles in determining whether a shareholder-guaranteed corporate debt is in substance a capital contribution.[13]

It is appropriate to consider traditional debt-equity factors in determining whether a shareholder-guaranteed corporate debt is in substance a capital contribution because such factors facilitate a determination of whether the funds advanced to a corporation were placed at the risk of the corporation's business. *In re Lane, supra* at 1314. Funds placed at the risk of the corporation's busi-

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should be bound by Circuit Court precedent even when the case is not appealable to that Circuit Court. See Geier, "The Emasculated Role of Judicial Precedent in the Tax Court and Internal Revenue Service," 39 Okla. L. Rev. 427 (1986). At any rate, were this case appealable to the First, Fifth, Ninth, or Eleventh Circuit Courts of Appeal, *Golsen v. Commissioner, supra,* might well have mandated a result different from the result reached by the majority.

[13] In *Brown v. Commissioner,* 706 F.2d 755, 756 (6th Cir. 1983), affg. T.C. Memo. 1981-608, the Sixth Circuit accepted the Tax Court's holding that, with respect to the transaction there at issue, "the substance matched the form." The Sixth Circuit did not reveal the analysis it utilized in deciding to accept the Tax Court's holding, but it clearly did not refuse to apply traditional debt-equity principles in making that decision.

ness represent equity, not debt. *Slappey Drive Ind. Park v. United States,* 561 F.2d 572 (5th Cir. 1977). As a general rule, third-party creditors, such as the Bank of Virginia herein, seek a more reliable investment for the funds they advance and avoid placing such funds at the risk of a corporation's business. Where such a third-party creditor makes a loan to a corporation, such loan is guaranteed by the corporation's shareholders, and the proceeds of such loan are ultimately placed at the risk of the corporation's business, the loan is properly treated as made by the third-party creditor to the shareholder/guarantors. As to the third-party creditor, the money lent is not at the risk of the corporation's business because the third-party creditor looks to the guarantor for repayment. As to the shareholder/guarantor, the money is at the risk of the corporation's business and is treated as an equity investment.

For the foregoing reasons, I believe that the majority inauspiciously erred in deciding not to apply traditional debt-equity principles to the issue presented.

II. Two types of economic outlay exist.

The majority opinion, citing *Brown v. Commissioner,* 706 F.2d 755 (6th Cir. 1983), affg. T.C. Memo 1981-608, states that to increase the basis in the stock of a subchapter S corporation, there must be an economic outlay. Majority slip op. at 10. I agree that economic outlay is required. However, because the majority did not determine the substance of the transaction by applying traditional debt equity factors, the majority did not discern the

existence of a second type of economic outlay, the type that petitioners have proven to be present here.

The economic outlay requirement was born of the Supreme Court's opinion in *Putman v. Commissioner,* 352 U.S. 82 (1956). See *Perry v. Commissioner,* 47 T.C. 159, 164 (1966). There a shareholder had guaranteed a loan by a third-party creditor to the shareholder's corporation. The shareholder was required by the third-party creditor to pay the corporation's loan in accordance with the guarantee. The Supreme Court held that upon payment of the loan, the shareholder was subrogated to the third-party creditor's rights, and the corporate debt to the third-party creditor was transformed into a corporate debt to the shareholder. The corporation was unable to pay its debt to the shareholder, and the Supreme Court held that the shareholder could deduct the amount paid pursuant to the guarantee as a bad debt but not as a loss incurred in a transaction entered into for profit.

The relevance of the *Putnam* opinion to the issue at hand is that, where a shareholder guarantees a loan to his corporation, the loan is not treated as indebtedness of the corporation to the shareholder until the shareholder pays the loan pursuant to the guarantee. Upon payment of the loan, the debt of the corporation to the third-party creditor instantly becomes a debt of the corporation to the shareholder. As such, the debt becomes an "indebtedness of the corporation to the shareholder" within the meaning of section 1374(c)(2)(B), and the amount of the shareholder's section 1374(c)(2) limitation is thereby increased. The payment by the shareholder/guarantor of the debt is the type of economic outlay referred to in *Brown v. Commissioner, supra.* See also *Raynor v. Commissioner, supra;*

Borg v. Commissioner, supra; and *Perry v. Commissioner,* 47 T.C. 159, 164 (1966).

The applicability of *Putman* extends only so far as the debt is initially the debt of the corporation. See *In re Lane, supra* at 1319; *Casco Bank & Trust Co. v. United States,* 544 F.2d 528 (1st Cir. 1976); and *Kavich v. United States,* 507 F. Supp. 1339 (D. Neb. 1981).[14] In *Putnam,* the debt was the corporation's debt prior to the payment by the shareholder. There was no allegation or suggestion that the debt was the shareholder's prior to such time. For Federal tax purposes, where the debt is treated initially as the debt of the shareholder, payment of the debt by the shareholder will not result in a subregation of creditors but rather will result in the extinguishment of the debt.

That is not to say that there can be no economic outlay where the debt is initially treated as the shareholder/guarantor's debt. In such a situation, the shareholder/guarantor's deemed transfer of the loan proceeds to the corporation is the economic outlay. *Selfe v. United States, supra.* The economic outlay occurs upon the third-

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[14] In *In re Lane, supra,* relying on *Casco Bank & Trust Co. v. United States, supra,* and *Kavich v. United States, supra,* the Eleventh Circuit examined traditional debt-equity principles to determine that, as of the time the taxpayer guaranteed a nominal debt of his corporation to a bank, he, not his corporation, was in substance the debtor. The nominal corporate debt was treated as the taxpayer's debt with the loan proceeds being deemed transferred from the bank to the taxpayer to his corporation, with the latter transfer being a contribution to capital, not a loan. The Eleventh Circuit held that *Putnam v. Commissioner,* 352 U.S. 82 (1956), was not applicable and that the taxpayer was not entitled to a bad debt deduction.

party creditor's disbursement of the loan proceeds, which are deemed transferred from the third-party creditor to the shareholder/guarantor to the corporation. *Selfe v. United States, supra; In re Lane, supra.* Thus there are two types of economic outlay: the economic outlay a la *Putnam* where the debt is initially treated as a corporate debt and the shareholder/guarantor pays the debt pursuant to the guarantee; and the economic outlay a la *In re Lane* where the debt is initially treated as the shareholder's debt and the loan proceeds are deemed transferred from the third-party creditor to the shareholder to the corporation.

The majority assumed there to be but one type of economic outlay, economic outlay a la *Putnam*. Constrained by this erroneous assumption, the majority correctly concluded that petitioners failed to make an economic outlay (economic outlay a la *Putnam*) because petitioners had not paid the loan nominally made by the Bank of Virginia to VAFLA. However, had the majority not been constrained to such erroneous assumption, the majority would have considered the existence of the second type of economic outlay, economic outlay a la *In re Lane*. The majority's refusal to consider the existence and presence in this case of economic outlay a la *In re Lane* ultimately led the majority to reach the wrong result in this case.

III. Application of traditional debt-equity principles in the present case indicates that petitioners' guarantee should be considered a capital contribution.

The traditional debt-equity factors include the following: (1) The label given the instrument; (2) the pres-

ence or absence of a fixed maturity date; (3) the source of payments thereon; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to other creditors; (7) the intent of the parties; (8) "thin" or inadequate capitalization; (9) identity of interest between creditors and stockholders; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets, and (13) the failure of the debtor to repay on the due date or to seek a postponement. *In re Lane, supra; Texas Farm Bureau v. United States*, 725 F.2d 307, 311 (5th Cir. 1984); *Estate of Mixon v. United States*, 464 F.2d 394, 410 (5th Cir. 1972); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).[15] These various factors are not equally significant. "The object of the inquiry is not to count factors, but to evaluate them." *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969).

At first blush the transaction at issue has the outward appearance of a debt transaction – a guaranteed loan with scheduled repayments. However, other factors clearly indicate the equity nature of the transaction.

Although the Bank of Virginia was nominally to look to VAFLA for repayment of the $300,000 loan, it is apparent that the Bank of Virginia looked solely to the share-

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[15] See also section 385, the text of which is reproduced in footnote 8 in the majority opinion. Though section 385 was added by the Tax Reform Act of 1969, Pub. L. 91-172, sec. 415(a), 83 Stat. 487, 613, no regulations under this provision are currently in effect.

holder/guarantors for repayment.[16] The shareholder/guarantors executed the guarantees prior to the time the Bank of Virginia advanced the loan proceeds. Their aggregate net worth was ten times the amount of the loan and the aggregate value of their quick assets was slightly greater than the amount of the loan. "The loan was approved only because of the financial strength of the guarantors." Majority slip op. at 6.

VAFLA's financial condition at the time the loan was made illustrates why the Bank of Virginia based its approval solely on the guarantees of the shareholder/guarantors. VAFLA's liabilities exceeded the value of its assets by $82,410.16. During its first three months of operations, it had lost $142,410.16. Its principal asset, and essentially its only asset, Six-Gun Park, was mortgaged to the previous owner of Six-Gun Park. The Bank of Virginia did not obtain a security interest in any of VAFLA's assets nor did it obtain a pledge of VAFLA's accounts receivable. The Bank of Virginia apparently viewed VAFLA's financial condition and the preexisting mortgage as making such courses of action futile.

VAFLA's financial statements as of September 30, 1979, less than one month after the Bank of Virginia advanced the $300,000, paint an even bleaker picture of VAFLA's financial condition. During its first taxable year, a short year, VAFLA lost $345,370.20. It then had a negative net worth of $185,370.20. Its debt-to-equity ratio was

[16] VAFLA apparently intended for the Bank of Virginia to look to the shareholder/guarantors for repayment as well. VAFLA reported the $300,000 loan as a liability to shareholders, not as a liability to the Bank of Virginia.

over 10-to-1. Its current assets of $42,041.10 were greatly overshadowed by its current liabilities of $294,321.65. VAFLA was a thinly capitalized corporation. See *Plantation Patterns, Inc. v. Commissioner, supra* at 722.

VAFLA could not have borrowed money from a third-party creditor such as the Bank of Virginia without outside support, such as guarantors. A portion of the $300,000 loan proceeds, at least $162,736.83,[17] was used to acquire capital assets or used to reduce the outstanding balance of indebtedness incurred to acquire capital assets. See *Plantation Patterns, Inc. v. Commissioner, supra* at 722. ("Of critical importance in determining whether financial input is debt or equity is whether or not the money is expended for capital assets.") I consider the expenditure of funds to reduce debt incurred to acquire capital assets to be tantamount to expending such funds to acquire capital assets, particularly where, as here, there is only a short period of time between incurring debt to acquire capital assets and reducing such debt with other borrowings.

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[17] The $162,736.83 figure was arrived at as follows: During VAFLA's taxable year ended September 30, 1979, VAFLA used funds to (1) acquire capital assets, (2) reduce the outstanding balance of indebtedness incurred to acquire capital assets, (3) pay organizational expenses, (4) prepay insurance, (5) purchase inventory, and (6) finance its operations. As of September 30, 1979, VAFLA had $4,200 in cash. Accordingly, it expended $295,800 on a combination of the six items described above. Financing operations required $102,009.63 [VAFLA's loss for its taxable year ended September 30, 1979, was $345,370.20. However, several of the items contributing to VAFLA's loss did not require the expenditure of cash during

(Continued on following page)

During the years in issue, VAFLA made principal payments on the $300,000 loan and all of the interest payments. The shareholder/guarantors made no payments of principal or interest on the $300,000 loan. I do not consider this factor to be indicative of a true debt transaction. "The transaction must be judged on the conditions that existed when the deal was consummated, and not on conditions as they developed with the passage of

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(Continued from previous page)

such year. They were: depreciation – $88,845.35; accrued but unpaid sales tax – $1,969.91; accrued but unpaid property tax – $13,511.14; accrued but unpaid interest – $69,183.22; and various accrued but unpaid items represented by accounts payable – $69,850.95. After adjusting for these items, VAFLA made cash expenditures to finance its operations of only $102,009.63.], the purchase of inventory required $5,079.29 [The inventory may have been purchased on credit. If so, $5,079.29 of the $69,850.95 of accounts payable should have been considered incurred to acquire inventory and should not have been considered an accrued but unpaid item in determining the amount of VAFLA's cash expenditures to finance its operations. See the immediately preceding bracketed material. As such, VAFLA's cash expenditures to finance its operations would be $5,079.29 more and its cash expenditures to purchase inventory $5,079.29 less. The items would cancel one another out in determining the amount expended by VAFLA to acquire capital assets and to reduce the outstanding balance of indebtedness incurred to acquire capital assets.], the prepayment of insurance required $25,282.87, and the payment of organizational expenditures required $691.38 [Organizational expenditures may have been paid with credit. See the immediately preceding bracketed material.]. Accordingly, at least $162,736.83 of the $300,000 loan proceeds was used to acquire capital assets or to reduce the outstanding balance of debt incurred to acquire capital assets.

time." [Citations omitted.] *Plantation Patterns, Inc. v. Commissioner, supra* at 723. At any rate, VAFLA was able to make the principal and interest payments only as a result of $800,000 of loans and shareholder contributions.[18]

Not all of VAFLA's shareholders guaranteed the $300,000 loan. However, shareholders other than petitioners, both guarantors of the $300,000 loan, advanced $800,000 to VAFLA as loans and capital contributions.[19] The $800,000 received from other shareholders may have made the totals of each of the shareholders' loans and capital contributions to VAFLA proportionate to their stockholdings in VAFLA.

The Bank of Virginia's approval of the $300,000 loan was based solely on the guarantees of the shareholder/guarantors. The financial health of the shareholder/guarantors, vigorous, and VAFLA, feeble, indicates that the Bank of Virginia prudently and appropriately looked solely to the shareholder/guarantors for repayment. "Under the principles of *Plantation Patterns*, a shareholder guarantee of a loan may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor. Essential to the *Plantation Patterns* court's analysis was that the notes guaranteed by the shareholder were issued by a

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[18] The September 30, 1980, financial statements show that during VAFLA's taxable year ended on September 30, 1980, VAFLA received from shareholders $600,000 reported as a loan and $200,000 reported as a capital contribution. Petitioners did not participate in either the $600,000 or the $200,000 advance.

[19] See n. 18, *supra*.

thinly capitalized corporation and had more equity characteristics than debt." *Selfe v. United States, supra* at 774. VAFLA was thinly capitalized. More than half of the $300,000 was used to acquire capital assets or to reduce the outstanding balance of indebtedness used to acquire capital assets. VAFLA could not have borrowed money from a third-party creditor such as the Bank of Virginia without outside support, such as guarantors. Payments on the $300,000 loan were made from funds provided by shareholders. I would hold that the Bank of Virginia in substance lent the $300,000 to the shareholder/guarantors who made a capital contribution thereof to VAFLA.[20] As a result, petitioners herein, two of the shareholder/guarantors, should be entitled to an increase in the amount of their section 1374(c)(2) limitation.

To determine the amount of the section 1374(c)(2) limitation each petitioner is entitled to, I would look to state law to determine what each petitioner's legal rights and obligations are as a result of their guaranty of the $300,000 loan. See *Burnet v. Harmel,* 287 U.S. 103, 110 (1932). ("The state law creates legal interests but the federal statute determines when and how they shall be taxed.") The guaranty signed by petitioners states that it "shall be governed and construed in accordance with the

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[20] I recognize that a corporation will lose its status as an electing small business corporation if it has more than one class of stock. Sec. 1371(a)(4). I do not consider the seven shareholder/guarantors' deemed equity investments to give rise to a second "class of stock" within the meaning of section 1371(a)(4). See *Amory Cotton Oil Co. v. United States,* 468 F.2d 1046 (5th Cir. 1972); *Estate of Allison v. Commissioner,* 57 T.C. 174 (1971); *Stinnett v. Commissioner,* 54 T.C. 221 (1970).

laws of the State of Virginia." Accordingly, I would look to Virginia State law.

Each of the shareholder/guarantors bound themselves to jointly and severally guarantee the $300,000 indebtedness of VAFLA to the Bank of Virginia. Although the shareholder/guarantors may have owned various percentages of VAFLA, their obligations arising from their guarantees were identical.[21] See *Cooper v. Greenberg*, 191 Va. 495, 61 S.E.2d 875, 877 (1950). Pursuant to the guarantees, the Bank of Virginia could proceed against any one of the shareholder/guarantors for the full amount of the indebtedness without first attempting to collect from VAFLA. A shareholder/guarantor required to pay the indebtedness could proceed against the other shareholder/guarantors pursuant to the equitable principle of contribution "that where two or more persons are subject to a common burden it shall be borne equally, since the law implies a contract between them to contribute ratably towards the discharge of the obligation." *Wiley N. Jackson Co. v. City of Norfolk*, 197 Va. 62, 87 S.E.2d 781, 784 (1955).

Although the shareholder/guarantors were each obligated to pay the full amount of VAFLA's indebtedness to the Bank of Virginia, I, would conclude in light of

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[21] Respondent contends and I agree that petitioner Anthony D. Cuzzocrea should be treated no differently than the other shareholder/guarantors. I consider his guarantee which is limited to $300,000 "plus any other indebtedness related thereto and any costs and expenses *** incurred *** to enforce this guaranty" to be, in effect, indistinguishable from the guarantees of the other shareholder/guarantors.

their rights to contribution that each shareholder/guarantor was effectively obligated to pay only their aliquot portion of the indebtedness. See *Cooper v. Greenberg, supra.*[22] Since there were seven shareholder/guarantors, each was effectively obligated to pay one-seventh of the $300,000 debt or $42,857.[23] I would conclude that both petitioners should be deemed to have made a contribution to VAFLA's capital in the amount of $42,857.

A collateral issue presented by the manner in which I would decide this case is the proper treatment of principal and interest payments made by VAFLA. Since the $300,000 received by VAFLA would be treated as a capital contribution, the payments of principal and interest made by VAFLA would have to be treated as cash distributions by VAFLA to the shareholder/guarantors, one-seventh each, and as payments of principal and interest by the shareholder/guarantors, one-seventh each, to the Bank of Virginia.[24]

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[22] See also *In re Breit,* 460 F. Supp. 873, 876 n.3 (E.D. Va. 1978). ("Their fellow guarantors *** were equally liable in the event of nonpayment by the corporation, and appellants failed to show why all the guarantors should not share equally in the deduction.")

[23] The determination of the number of shareholder/guarantors and the amount of the obligation is to be made as of the time the loan proceeds are advanced because it is at this time that the shareholder/guarantors are deemed to make a capital contribution.

[24] See *Plantation Patterns Inc. v. Commissioner,* T.C. Memo. 1970-182, wherein respondent was contending that only the principal payments made by the corporation on the shareholder-guaranteed debt were taxable to the taxpayer-shareholders because of the offsetting interest deductions which would be available to them.

V. Conclusion

The majority opinion has reached an incorrect result because (1) it did not recognize the distinctions between section 1374(c)(2)(A) and section 1374(c)(2)(B), (2) it incorrectly stated the *Blum* opinion, (3) it unsoundly refused to follow *Selfe,* (4) it erroneously believed subchapter C precedent is not applicable to a subchapter S corporation, (5) it unsoundly refused to apply traditional debt-equity principles to determine the substance of the transaction at issue, (6) it refused to follow without discussion numerous opinions of this and other courts, and (7) it refused to recognize the existence and presence of economic outlay a la *In re Lane.* This Court has dangled an elusive carrot before taxpayers' eyes for over 15 years stating that on the proper showing, a shareholder-guaranteed corporate debt can be characterized as a capital contribution.[25] Petitioners have here made the proper

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[25] See *Blum v. Commissioner,* 59 T.C. 436 (1972); *Schneiderman v. Commissioner,* T.C. Memo. 1987-551 ("A loan will be deemed to have been made to its guarantors only if the guarantors can show, among other things, that the lender looked primarily to them for repayment."); *Bader v. Commissioner,* T.C. Memo. 1987-30 ("[P]etitioners [shareholder/guarantors] have not established that CNB [the third-party creditor] looked primarily to them for satisfaction of the debt."); *Blackman v. Commissioner,* T.C. Memo. 1981-244 ("Although we accept petitioners' general proposition that the substance of a transaction and not merely the form in which it is cast controls its treatment for tax purposes, petitioners have failed to convince this Court that the guaranteed loans should be characterized as indirect capital contributions."); and *Albert v. Commissioner,* T.C. Memo. 1980-567 ("[T]his is not a case where a Subchapter

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showing, to which the majority states, "we were only kidding."

For the foregoing reasons, I respectfully dissent.

(Continued from previous page)

S corporation was thinly capitalized, or insolvent at the time of the [guaranteed] loan. *** Nor is there any suggestion from the facts herein that the guaranteed loan was in substance an equity contribution by the taxpayer.").

STIPULATION OF FACTS

In accordance with Tax Court Rule 91(e), it is hereby stipulated that, for the purposes of these consolidated cases, the following statements are accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof, are agreed to be authentic, and are hereby before the Court as evidence for consideration pursuant to Rule 122. All objections to this stipulation and its exhibits are expressly waived unless otherwise stated in this stipulation.

1. At the time of the filing of the petition, petitioner Charles D. Fox, III, Co-Executor for the Estate of Daniel Leavitt and Executor of the Estate of Evelyn M. Leavitt, resided at 3711 Peakwood Drive, S.W., Roanoke, Virginia 24014. Copies of the joint individual income tax returns, Forms 1040, of Daniel and Evelyn M. Leavitt for the years 1979 and 1980 are attached hereto as Joint Exhibits 1-A and 2-B, respectively.*

2. At the time of filing their petition, petitioners Anthony D. Cuzzocrea and Marjorie F. Cuzzocrea resided at 3815 Mudlick Road, S.W., Roanoke, Virginia 24015. Copies of the joint individual income tax returns, Forms 1040, of Anthony D. and Marjorie F. Cuzzocrea for the years 1979, 1980 and 1981 are attached hereto as Joint Exhibits 3-C, 4-D and 5-E, respectively.

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*For the convenience of the Court and in the interest of brevity, Joint Exhibits referred to as attachments have not been included in the Appendix.

3. At the time of filing its petition, petitioner Valley Pathology Associates, Inc., had its principal office at 1321 Third Street, S.W., Roanoke, Virginia. Copies of the corporate income tax returns, Forms 1120, of Valley Pathology Associates, Inc., for the taxable years ended June 30, 1980, June 30, 1981, and June 30, 1982, are attached hereto as Joint Exhibits 6-F, 7-G and 8-H, respectively.

4. At the time of filing their petition, petitioner Dominion Trust Company, Executor of the Estate of Wolfgang A. Wirth, had its principal office at 201 South Jefferson Street, Roanoke, Virginia, and Verla J. Wirth resided at 6184 Steeple Chase Drive, Salem, Virginia 24153. Copies of the joint individual income tax returns, Forms 1040, of Woldfgang A. and Verla J. Wirth for the years 1979, 1980 and 1981 are attached hereto as Joint Exhibits 9-I, 10-J and 11-K, respectively.

5. VAFLA Corporation, a Virginia corporation ("the Corporation"), was incorporated on February 20, 1979. The Corporation timely made a Subchapter S Corporation election of its first tax year and has remained a Subchapter S Corporation throughout the tax years before the Court.

6. The Corporation was formed to acquire and operate the Six-Gun Territory Amusement Park near Tampa, Florida.

7. The initial issue of capital stock of VAFLA Corporation took place in March, 1979, and consisted of 100,000 shares.

8. Daniel Leavitt and Anthony D. Cuzzocrea each paid $10,000.00 cash for their shares on or before September 30, 1979.

9. The first taxable year of VAFLA Corporation was a short year (seven months) ending on September 30, 1979. As of September 30, 1979, the Corporation had suffered a net operating loss of $265,566.47 and had a retained earnings deficit of $345,370.20. Attached hereto as Joint Exhibit 12-L is the financial statement and tax return (Form 1120S) for the year ended September 30, 1979.

10. The second taxable year of VAFLA Corporation ended on September 30, 1980. As of September 30, 1980, the Corporation had suffered a net operating loss of $482,181.22 and had a retained earnings deficit of $1,093,383.56. Attached hereto as Joint Exhibit 13-M is the financial statement for the year ended September 30, 1980.

11. The second taxable year of VAFLA Corporation ended on September 30, 1981. As of September 30, 1981, the Corporation had suffered as net operating loss of $475,175.70 and had a retained earnings deficit of $1,908,680.22. Attached hereto as Joint Exhibit 14-N is the financial statement for the year ended September 30, 1981.

12. Attached hereto as Joint Exhibits 15-O and 16-P are the U.S. Small Business Income Tax Returns, Forms 1120S, for the years ended September 30, 1981, and September 30, 1982, respectively.

13. From August 2, 1979, through 27, 1979, Anthony D. Cuzzocrea and Daniel Leavitt, as well as other shareholders signed guarantee agreements whereby they agreed to be jointly and severally liable for all indebtedness of VAFLA Corporation to Bank of Virginia. All of the

personal guarantees were unlimited except that the guarantee of Anthony D. Cuzzocrea was limited to $300,000.00. Copies of the guarantee agreements executed by Anthony D. Cuzzocrea and Daniel Leavitt are attached hereto as Joint Exhibits 17-Q and 18-R, respectively.

14. On or before September 30, 1979, VAFLA Corporation borrowed $300,000.00 from Bank of Virginia, as evidenced by its promissory note dated September 12, 1979, attached hereto as Joint Exhibit 19-S.

15. Charles M. Harris, Jr., then Vice President of Bank of Virginia, was the loan officer in charge of the VAFLA Corporation loan account. His letter of March 7, 1983, and affidavit regarding the circumstances surrounding the origination of the loan are attached hereto as Joint Exhibits 20-T and 21-U, respectively, and are before the Court in lieu of Mr. Harris' testimony for the petitioners.

16. At the time the loan was made, VAFLA Corporation's liabilities exceeded its assets, and VAFLA Corporation had so little cash available that it could not meet its cash flow requirements. Virtually all of the assets of the Corporation had been put up as security for a purchase money indebtedness of approximately $1,000,000.00 to National Service Industries, Inc.

17. The Bank of Virginia loan was consistently shown on VAFLA Corporation's financial statements and tax returns for its fiscal years ending 1979, 1980, and 1981 as a loan from shareholders.

18. The following are all of the principal payments made to Bank of Virginia from VAFLA corporation during its fiscal years ending in 1979, 1980 and 1981:

December 26, 1979	$10,000.00
July 15, 1980	$10,000.00
January 6, 1981	$10,000.00

19. All interest payments were made by VAFLA Corporation.

20. The business percentage of the following shareholders' use of corporate automobiles supplied by Valley Pathology Associates, Inc., is as follows:

1980	Leavitt	–	44%
	Wirth	–	74%
	Cuzzocrea	–	40%
1981	Wirth	–	68%
	Cuzzocrea	–	45%
1982	Wirth	–	60%
	Cuzzocrea	–	84%

21. The fair market value of the 1978 Buick Regal purchased by Doctor Cuzzocrea from Valley Pathology Associates, Inc., was $4,665.00 on the date of the purchase. Doctor Cuzzocrea paid $3,779.00 for the automobile, so the dividend to Doctor Cuzzocrea from this bargain sale was $886.00.

22. Attached hereto are copies of the Forms K-1 issued by VAFLA Corporation to Doctor Cuzzocrea for the tax years ending September 30, 1979, September 30, 1980, September 30, 1981, and to Daniel Leavitt for the tax year ending September 30, 1979, as Joint Exhibits 22-V through 25-Y, respectively.

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ESTATE OF WOLFGANG A. WIRTH, DECEASED, DOMINION TRUST COMPANY, EXECUTOR, AND VERLA J. WIRTH, Petitioners,	)	Docket No. 36455-84
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

Affidavit of Charles M. Harris, Jr.

I, Charles M. Harris, Jr., held the position of Vice President of Bank of Virginia in charge of the commercial area in Roanoke, Virginia, from March, 1978 through September, 1983. I am presently Vice President of the Northern Virginia Group of American Security Bank, N.A.

In my capacity as a Vice President of the Bank of Virginia, I was one of the prinicipal bank personnel connected with the origin of a $300,000.00 loan involving VAFLA Corporation. This loan was approved in August, 1979. After the initial loan was granted, I was the loan officer in charge of the account until September, 1983, when I moved to northern Virginia.

The purpose of the loan was to fund the existing and anticipated operating deficits of VAFLA Corporation. VAFLA Corporation had acquired and was operating the Six-Gun Territory Amusement Park near Tamp, Florida.

In processing the loan, we were furnished with a statement of income for VAFLA Corporation for the months of March, April and May of 1979, the first three months of VAFLA Corporation's operations. The statement showed that during those first three months of operations the Corporation experienced a loss of $142,410.16, resulting in a negative net worth of $82,410.16 as of May 31, 1979. Virtually all of the assets of the corporation consisted of land, improvements, buildings, rides and equipment located in Florida, and those assets were already encumbered as collateral for a purchase money liability to National Service Industries, Inc.

Due to the fact that this Corporation had virtually all of its assets outside of our market area, that the assets were highly specialized, that the assets were already pledged to somebody else, and that the firm lost money resulting in a deficit net worth, we would not consider granting a loan without outside support or guarantors. In my position as a loan officer, I was familiar with the lending criteria of Roanoke area banks. In my opinion as a loan officer, no other Roanoke bank would have made this loan without outside support or guarantees.

Seven of the shareholders of the Corporation agreed to personally guarantee the $300,000.00 loan. Those shareholders, Lucian Grove, Daniel Leavitt, Anthony Gacek, Charles Bray, Paul Dodson, William Valentine and Anthony Cuzzocrea, had an aggregate net worth (according to their financial statements submitted to the Bank) at the time of the loan of $3,407,286.00 and immediate liquidity (cash and securities) of $382,542.00. Based on this, and based on this alone, the loan was approved.

Under penalties of perjury, I hereby declare that the above is true and correct to the best of my knowledge and belief.

/s/ Charles M. Harris, Jr.
Charles M. Harris, Jr.

District) to-wit:
of Columbia)
)
___of___ ______)

After first being duly sworn, Charles M. Harris, Jr., stated before me, a Notary Public in and for the District of Columbia, that the above was true and accurate to the best of his knowledge and belief, this 19th day of November, 1985.

/s/ Leroy R. Jenkins, Jr.
Notary Public

My commission expires:
July 14, 1987

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No. 89-280

In the Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF DANIEL LEAVITT, DECEASED, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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17pp

QUESTION PRESENTED

Whether the shareholders of a Subchapter S corporation increased their basis in the corporation (and therefore their ability to offset corporate losses against their income from other sources under 26 U.S.C. 1374(c)(2) (1976)) merely by guaranteeing the corporation's debt to a bank.

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In the Supreme Court of the United States

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No. 89-280

ESTATE OF DANIEL LEAVITT, DECEASED, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 875 F.2d 420. The opinion of the Tax Court (Pet. App. 21-71) is reported at 90 T.C. 206.

JURISDICTION

The judgment of the court of appeals was entered on May 19, 1989. The petition for a writ of certiorari was filed on August 17, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1979, Daniel Leavitt[1] spent $10,000 to purchase shares of stock in VAFLA Corporation, a Virginia cor-

[1] The petitioners in this case are the Estate of Daniel Leavitt and the Estate of Evelyn M. Leavitt, which is a party to this proceeding solely because Evelyn Leavitt filed a joint income tax return for 1979 with Daniel Leavitt.

poration formed earlier that year to acquire and operate an amusement park near Tampa, Florida. After its first few months of operation, VAFLA's liabilities exceeded its assets, and it was unable to meet its cash flow requirements. Virtually all of the corporation's assets were already encumbered by a purchase-money mortgage and could not be used as collateral. In August 1979, Leavitt and six other shareholders signed guarantee agreements whereby each agreed to be jointly and severally liable for all of VAFLA's indebtedness to the Bank of Virginia. On September 12, 1979, VAFLA borrowed $300,000 from the Bank of Virginia, giving its note in return. The bank would not have made the loan without receiving the shareholders' personal guarantees. Pet. App. 4-5, 24-25.

The bank loan was reflected on VAFLA's financial statements and tax returns as a loan from the shareholders who had guaranteed the loan. VAFLA made all of the loan repayments to the bank, however, and the shareholders were never asked to make good on their guarantees. Moreover, neither the corporation nor any of the shareholders who had acted as guarantors treated the corporate payments on the loan as constructive income to the shareholders. Pet. App. 5.[2]

VAFLA elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code, Sections 1371 *et seq.*[3] Under these provisions, the income of an electing small business corporation is not subject to the corporate income tax, but rather is taxed on a pro rata basis as income to

[2] If the corporation paid a debt that was personally owed by a shareholder, that payment would be income to the shareholder as a constructive dividend from the corporation.

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)) (the Code or I.R.C.), as in effect during 1979, the year in issue.

the shareholders. See I.R.C. §§ 1372, 1373. Any net operating loss incurred by a Subchapter S corporation is similarly passed through to its shareholders, each of whom is entitled to deduct on his individual return his proportionate share of the loss (§ 1374(a)) – subject to a maximum that reflects the shareholder's investment in the corporation. The shareholder's deduction for a net operating loss incurred by a Subchapter S corporation is limited to the sum of (A) the shareholder's adjusted basis in the corporation's stock and (B) the adjusted basis of any indebtedness of the corporation to the shareholder (§ 1374(c)(2)).

In its first fiscal year, ended September 30, 1979, VAFLA incurred a net operating loss in the amount of $265,566 (Pet. App. 4 n.4). On their joint income tax return for 1979, Daniel and Evelyn Leavitt claimed a loss of $13,808, based upon the Leavitts' pro rata share of the corporation's loss. On audit, the Commissioner invoked Section 1374(c)(2) to limit the deduction to $10,000 – the amount of cash Leavitt had invested in the corporation, and he accordingly asserted a deficiency in the Leavitts' income tax for 1979. Pet. App. 26.

2. Petitioners sought redetermination of the asserted deficiency in the Tax Court, which sustained the deficiency in a reviewed decision by a 19-1 vote (Pet. App. 21-71). The majority rejected petitioners' contention that Leavitt's guarantee of VAFLA's debt to the Bank of Virginia operated to increase the amount of the allowable loss deduction "cap" imposed by Section 1374(c)(2). The court explained that Leavitt's basis in his Subchapter S corporation stock was "cost," as established by Section 1012 of the Code. His ability to deduct losses under Section 1374(c)(2)(A) therefore was limited to his actual out-of-pocket investment in the corporation. Because the guarantees in the instant case had not involved "an economic outlay or a realization of income" (Pet. App. 30), the court concluded that the

guarantees did not serve to increase the shareholders' bases in the corporation. *Id.* at 30-32.

The Tax Court specifically rejected petitioners' contention that the bank loan transaction should be recast as a loan from the bank to the shareholders, followed by contribution of the loan proceeds by the shareholders to the corporation (a contribution that would have increased their equity in the corporation) (Pet. App. 33-41). The court noted that the bank in fact had lent the money to the corporation, that it had earmarked the loan proceeds for use in the corporation's business, and that the shareholders were not free to dispose of the proceeds as they wished. The court further noted that the corporation's payments on the loan had not been treated as constructive income to the seven shareholders on either the corporate or individual returns for the years in issue. Accordingly, the court concluded that the substance of the bank loan transaction was fully consistent with its form as a loan to the corporation rather than to the shareholders. *Id.* at 33.

Because the shareholders had made no economic outlay at all in connection with the loan from the bank to the corporation, the court found it unnecessary to examine the factors usually applied to determine whether a debt transaction should be regarded as a contribution to equity. See Pet. App. 33-36 & n.8. Finally, the Tax Court expressed its disagreement with the Eleventh Circuit's view in *Selfe* v. *United States*, 778 F.2d 769 (1985), that a shareholder's guarantee of corporate debt can increase his basis if the lender was looking primarily to the shareholder for repayment (Pet. App. 37-41). The Tax Court explained that this approach would allow the shareholders of Subchapter S corporations to avoid the specific limitation enacted by Congress that restricts the loss deductions of a Subchapter S shareholder "to the amount he has actually invested in the corporation" (*id.* at 38).

Three judges concurred only in the result. Judge Williams filed a separate opinion, stating that he agreed with the result reached by the majority but expressing the view that the majority had "unnecessarily reject[ed]" the reasoning of *Selfe* (Pet. App. 42-43). He explained that *Selfe* had involved a corporation wholly owned by one shareholder, where "the form of the transaction had no tax significance" (*id.* at 42), and he maintained that "the *Selfe* rationale can be correctly applied" in certain circumstances, "limited to cases involving the sole shareholder" (*id.* at 43).

Judge Fay dissented (Pet. App. 43-71). He argued that the rationale of *Selfe*—namely, "that traditional debt-equity principles are applicable in determining whether a shareholder-guaranteed subchapter-S corporate debt should be recharacterized as a capital contribution" (*id.* at 49)—is correct and is fully applicable to this case. He further concluded that these principles would justify treating the guarantee here as equity—*i.e.*, that the corporate bank debt should be viewed as a loan to the shareholders, followed by their contribution of the loan proceeds to the corporation—because the bank looked to the shareholders for repayment (*id.* at 61-66). Judge Fay proceeded to find that this conclusion required recharacterizing the corporation's loan repayments to the bank as cash distributions to the shareholders followed by payments by the shareholders of principal and interest to the bank (*id.* at 67).

3. The court of appeals affirmed (Pet. App. 1-20). It agreed with the Tax Court's conclusion that the shareholder guarantees gave rise to no increase in basis under Section 1374(c)(2), reasoning that petitioners "have experienced no * * * call as guarantors, have engaged in no economic outlay, and have suffered no cost" (Pet. App. 7). The court of appeals also declined to recast the bank loan to the corporation as a loan to the shareholders, followed by their contribution of the loan proceeds to the corporation. It ex-

plained that "taxpayers are liable for the tax consequences of the transaction they actually execute and may not reap the benefit of recasting the transaction into another one substantially different in economic effect that they might have made" (*id.* at 9). The court of appeals found no error in the Tax Court's determination that the substance of the transaction matched its form of a loan from the bank to VAFLA, not to the shareholders (*id.* at 10-11). The court specifically rejected petitioners' contention that the application of "debt-equity principles" requires treating the shareholder guarantees as if they constituted actual contributions to capital. The court explained that debt-equity principles become relevant only at the second stage of a two-part inquiry; they assist in classifying actual shareholder advances as either debt or equity, but furnish no basis for determining whether there has been an actual outlay in the first place. Here, where the Tax Court correctly found that the loan was made directly from the bank to the corporation, there is no occasion to examine the various debt-equity factors. *Id.* at 8-14.

The court proceeded to explain that, although it rejected petitioners' reliance on *Selfe*, it did not view that case as compelling a different result here (Pet. App. 14-20), and therefore it did not "reject the case completely" (*id.* at 16 n.15). The court stated that it did not disagree with the result in *Selfe*, which simply vacated the entry of summary judgment and remanded for further factual development, "to the extent that the *Selfe* court remanded because material facts existed by which the taxpayer could show that the bank actually lent the money to [the shareholder] rather than to the corporation" (*id.* at 19). The court also stated that, "[t]o the degree that the *Selfe* court agreed with *Brown* [v. *Commissioner*, 706 F.2d 755 (6th Cir. 1983)] that an economic outlay is required before a shareholder may increase her basis in a subchapter S corporation, *Selfe* does not con-

tradict current law or our resolution of the case before us" (Pet. App. 19). The court of appeals did reject, however, "the *Selfe* court's suggestion that debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation" (*id.* at 19-20).

ARGUMENT

The court of appeals correctly rejected petitioners' argument that Daniel Leavitt's and other shareholders' guarantee of a bank loan to their Subchapter S corporation increased their respective bases in the corporation's stock, thereby relaxing the limitation on their ability to offset the corporation's losses against their individual income from other sources. Moreover, this decision does not create a direct conflict in the circuits that warrants this Court's intervention. Accordingly, there is no reason for review by this Court.

1. Section 1374(c)(2) places a specific limitation on the ability of shareholders to offset the losses of their Subchapter S corporation against their income from other sources—keyed to the amount of their bases in their shares and any amounts that they have lent to the corporation. In the words of the Senate Report, Section 1374 limits the amount of the Subchapter S shareholders' deduction of the corporation's net operating losses "to the adjusted basis of the shareholder's investment in the corporation." S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958). The obvious intent of the limitation is to prevent individuals from using Subchapter S corporations as "tax shelters," *i.e.*, from using corporate losses that exceed their investment in the corporation to shelter from tax their income from other sources.

As the courts below held, Section 1374(c)(2) operates to implement this purpose by limiting a shareholder's deduction of corporate losses to the amount of his actual economic

outlay, thereby precluding deductions that exceed the amount of the economic loss suffered by the shareholder. Accordingly, the courts have repeatedly rejected the contention of Subchapter S shareholders that their personal guarantees of loans to their corporations operate to relax the Section 1374(c)(2) limitation by increasing their bases in the corporation's stock. See, *e.g.*, *Brown* v. *Commissioner*, 706 F.2d 755, 756 (6th Cir. 1983); *Underwood* v. *Commissioner*, 535 F.2d 309, 312 (5th Cir. 1976); *Frankel* v. *Commissioner*, 61 T.C. 343, 347 (1973), aff'd, 506 F.2d 1051 (3d Cir. 1974) (Table); *Perry* v. *Commissioner*, 47 T.C. 159, 163 (1966), aff'd, 392 F.2d 458 (8th Cir. 1968);[4] but see *Selfe* v. *United States*, *supra*. Only when a shareholder-guarantor actually is called upon to pay the debt he has guaranteed for the corporation does a loan guarantee yield an economic outlay that increases his basis in the corporation's stock. See I.R.C. § 1012; Treas. Reg. § 1.1012-1(a). In the words of the Sixth Circuit (*Brown* v. *Commissioner*, 706 F.2d at 757), "guaranteeing shareholders must make actual disbursements on the corporate indebtedness before they can augment their bases for the purpose of deducting net operating losses under § 1374." As that court explained (*id.* at 756), "[a]bsent such an outlay requirement, Subchapter S shareholders could readily skirt the limitation embodied in § 1374(c) * * * and thereby erect a tax shelter that Congress undoubtedly never intended to create."[5]

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[4] See also *Harrington* v. *United States*, 605 F. Supp. 53, 56 (D. Del. 1985); *Wheat* v. *United States*, 353 F. Supp. 720, 723 (S.D. Tex. 1973); *Neal* v. *United States*, 313 F. Supp. 393, 396 (C.D. Cal. 1970); *Borg* v. *Commissioner*, 50 T.C. 257, 264 (1968); *Raynor* v. *Commissioner*, 50 T.C. 762, 770-771 (1968).

[5] For example, in this case Daniel Leavitt invested only $10,000 in the corporation but he claimed loss deductions in excess of $13,000, even though he was not called upon during the year at issue to make

The courts below correctly rejected petitioners' contention that an economic outlay from the shareholders to the corporation should be imputed here by recasting the loan as one made directly to the shareholders, followed by their contribution of the loan proceeds to the corporation. It was the shareholders who determined how to structure the loan transaction, and their tax treatment should be governed by the transaction that actually occurred, not by one that they might have entered into. In the words of this Court, they "must accept the tax consequences of [their] choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route [they] might have chosen to follow but did not." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974); see also *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579 (1977).

Moreover, there is no basis for rejecting the finding of both courts below (see Pet. App. 10-11, 33) that the substance of the loan in this case was fully consistent with its form as a bank loan directly to the corporation. The loan proceeds were earmarked for use in the corporation's business and were not placed at the shareholders' disposal. Although the bank loan was shown on the corporation's books and tax returns as a loan from shareholders, the corporation made all payments of interest and principal with respect to the loans. Moreover, neither the shareholders nor the corporation treated these corporate payments as constructive income taxable to the shareholders, as would have been appropriate if the loan in fact were from the bank to the shareholders. See Pet. App. 19 n.19. Thus, the courts below correctly held that petitioners made no economic outlay to the corporation in the loan guarantee that would entitle them under Section 1374(c)(2) to deduct a loss

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any payment with respect to his guarantee and, indeed, his estate may never be required to do so.

greater than the $10,000 that Daniel Leavitt actually invested in the corporation.[6]

2. a. The court of appeals and the Tax Court correctly rejected petitioners' argument (Pet. 13-14) that the question whether a loan guarantee can increase the Section 1374(c)(2) limitation should be resolved by resort to the principles that are generally invoked to distinguish between debt and equity. This basic debt-equity analysis is applied by the courts to determine the character of funds actually advanced by a shareholder to a corporation. When the corporation is not being taxed under the special provisions of Subchapter S (*i.e.*, a Subchapter C corporation), whether a shareholder advance is classified as debt or equity has significant tax ramifications.[7] But the issue in this case turns on the *amount*

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[6] Petitioners briefly suggest that their proposed approach of allowing shareholder loan guarantees to raise the Section 1374(c)(2) cap should be adopted because it is good policy; they argue that guaranteed amounts are placed "at risk" and therefore should increase the shareholders' basis (Pet. 9) and that this approach would treat Subchapter S shareholders equitably as compared to limited partners in a partnership (Pet. 20). Whatever the merit of petitioners' policy arguments—and one commentator has taken the position that *the statute should be amended* so that loan guarantees relax the Section 1374 limitation (see I. Grant & W. Christian, *Subchapter S Taxation* § 19.7 (2d ed. 1980))—it is apparent that these arguments are properly addressed to Congress, not the courts. Petitioners' " 'hope' " that this result can be achieved " 'judicially rather than legislatively' " (see Pet. 20, quoting 8 ABA Sec. of Taxation Newsletter, *Tax Commentaries* 71 (Summer 1989)) is not consistent with the role of the courts in our system of government.

[7] For example, if a purported loan from a shareholder to his corporation is determined not to be debt, but instead to be a capital contribution, then interest deductions claimed by the corporation for payments to the shareholders would be treated as nondeductible dividends. Similarly, from the shareholder's perspective, amounts denominated as (nontaxable) repayments of the indebtedness would be treated as dividend distributions, which produce taxable income. See,

of petitioners' advances to the corporation, not the *character* of those advances. As the court of appeals noted (Pet. App. 13 n.12), it is irrelevant in the Section 1374 context whether a shareholder advance is classified as debt or equity, since the statute allows both debt and equity investments by the shareholder to increase the limitation on deductible losses. Thus, debt-equity principles are relevant only to what the court of appeals correctly characterized as the second stage of a two-part inquiry (see *id.* at 13-14)—whether a shareholder advance should be treated as debt or equity—that is not germane to the tax controversy in this case. Those principles shed no light on the threshold issue, which is the one that is controlling here—whether the shareholder has made any form of actual investment in the corporation.

b. Petitioners are correct in stating that the court of appeals' refusal to apply the debt-equity factors in this context is at odds with much of the Eleventh Circuit's reasoning in *Selfe* v. *United States*, *supra*. As the court below stated (Pet. App. 19-20), that opinion suggests that "debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation"—an approach that is inconsistent with the analysis of the decision below. But this disagreement does not warrant review by this Court.

The Eleventh Circuit's decision in *Selfe* does not irreconcilably conflict with the decision below. First, as the court of appeals explained (Pet. App. 19), the court in *Selfe* held only that the grant of summary judgment should be vacated and the case remanded for a factual inquiry into whether the loan was actually made to the shareholder, rather than to the corporation. Here, by contrast, the Tax Court found that the loan was actually made to the corporation. For that

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e.g., *Estate of Mixon* v. *United States*, 464 F.2d 394 (5th Cir. 1972); *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694 (3d Cir. 1968).

reason, the court below did not view its decision as irreconcilable with *Selfe* (see *id.* at 16 n.15). Second, as Judge Williams noted in his concurring opinion in the Tax Court (*id.* at 42-43), *Selfe* is factually distinguishable from the instant case because it involved a sole shareholder (and therefore there was considerably less practical difference than here between a loan to the corporation and a loan to the shareholders), whereas this case involved a loan guaranteed by some, but not all, of the multiple shareholders of the corporation. And finally, the statements of the Eleventh Circuit in *Selfe* stand alone in invoking debt-equity principles to determine the amount of the Section 1374 limitation on the loss deductions available to Subchapter S shareholders; no court has followed *Selfe* in this regard. See generally I. Grant & W. Christian, *Subchapter S Taxation* § 19.2 (Supp. 1989). Thus, there is no assurance that the Eleventh Circuit would have reached a result in this case different from that reached below.[8]

c. As the court of appeals explained (Pet. App. 12 n.11), the other cases relied upon by petitioners (see Pet. 9-10, 16) plainly do not conflict with the decision below. Both *Casco Bank & Trust Co.* v. *United States*, 544 F.2d 528 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977), and *Lane* v. *United States* (*In re Lane*), 742 F.2d 1311 (11th Cir. 1984), involved the classification as debt or equity of actual shareholder advances to Subchapter C corporations. Thus, these cases were not concerned with the fundamental question here – whether Daniel Leavitt made any kind of actual advance to his corporation in excess of $10,000. Similarly, both *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir.), cert. denied, 409 U.S. 1076 (1972), and *Murphy Logging*

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[8] Indeed, even the court of appeals in *Selfe* stated that an "economic outlay is required before a stockholder in a Subchapter S corporation may increase her basis" (778 F.2d at 772).

Co. v. *United States*, 378 F.2d 222 (9th Cir. 1967), involved guaranteed bank loans nominally made to Subchapter C corporations, and the issue was the factual one of whether the loan had in fact been made to the shareholder. In *Plantation Patterns*, the court concluded that the loan, in substance, had been made to the shareholder, and therefore he was charged with a constructive dividend when the corporation repaid the loan. In *Murphy Logging*, the court reached the opposite conclusion and refused to charge shareholders with constructive dividends. Neither case involved the limitations imposed by Section 1374(c)(2), and they have no bearing here where the Tax Court found that the substance of the loan matched its form, *i.e.*, that the loan in actuality was made to the corporation and hence did not represent any economic outlay on the part of the shareholders.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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